Chinese Economic Development Trends

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Outline

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- The Economic Fundamentals of the Chinese Economy
- The Macroeconomic Outlook
- The Sources of Sustainable Aggregate Demand
- Projections of the Future
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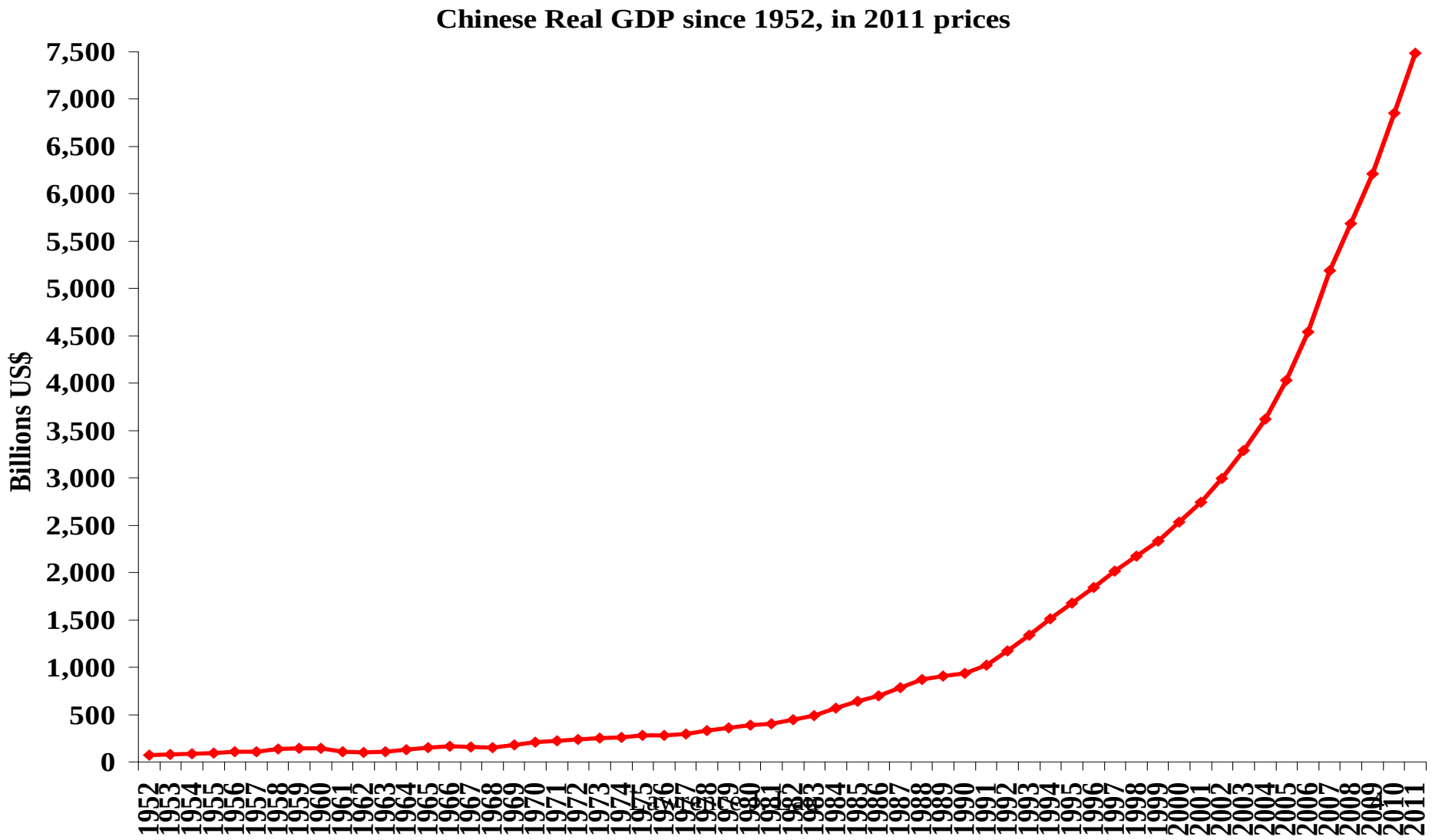
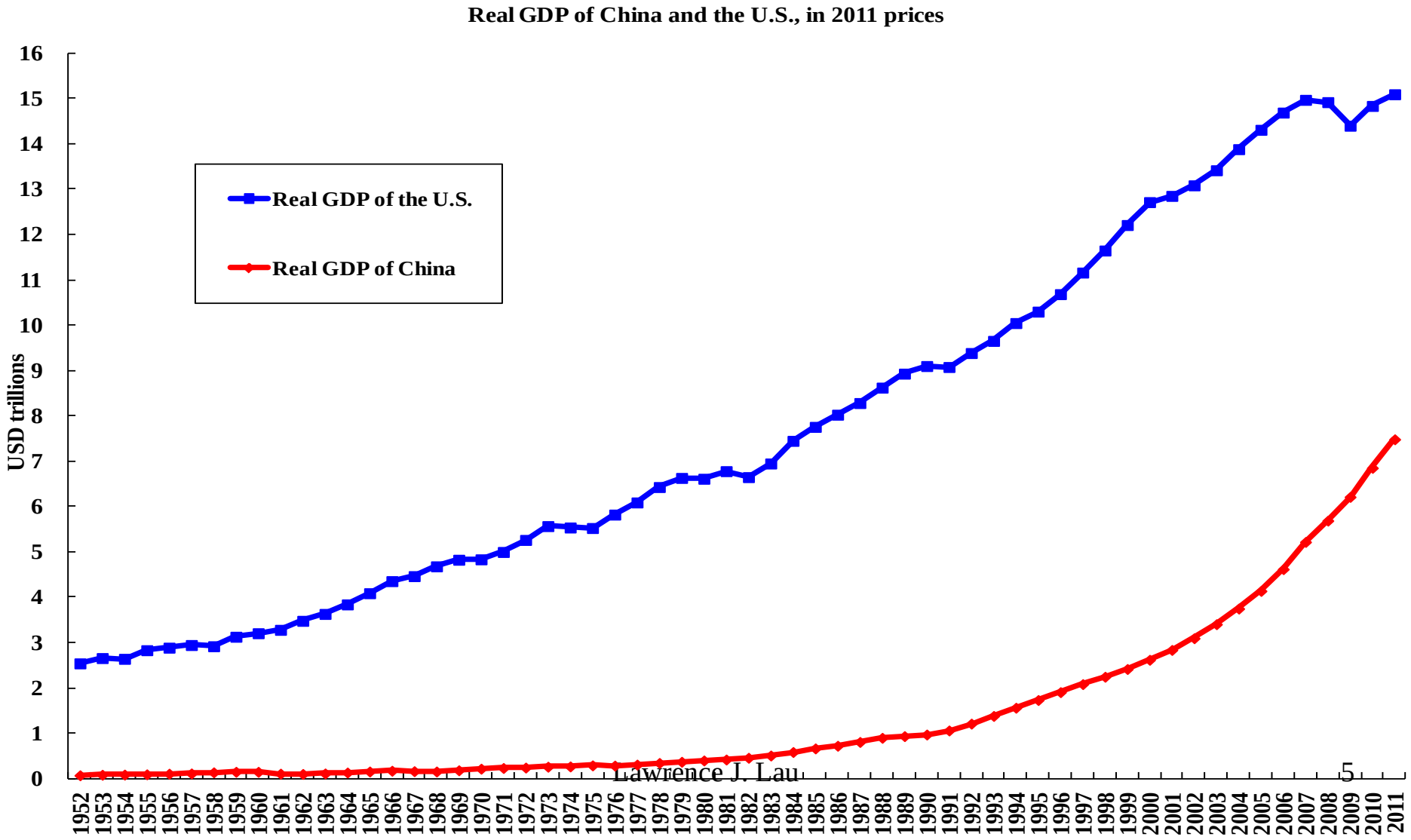
Introduction

- China has made tremendous progress in its economic development since it began its economic reform and opened to the World in 1978. China is currently the fastest growing economy in the World—averaging 9.8% per annum over the past 33 years. It is historically unprecedented for an economy to grow at such a high rate over such a long period of time.
- Between 1978 and 2011, Chinese real GDP grew almost 22 times, from US$333 billion to nearly US$7.5 trillion (2011 prices) to become the second largest economy in the World, after the U.S.
- By comparison, the U.S. GDP (approx. US$15.1 trillion) was 2 times Chinese GDP in 2011.

Chinese Real GDP in US$ Since 1952 (2011 Prices)



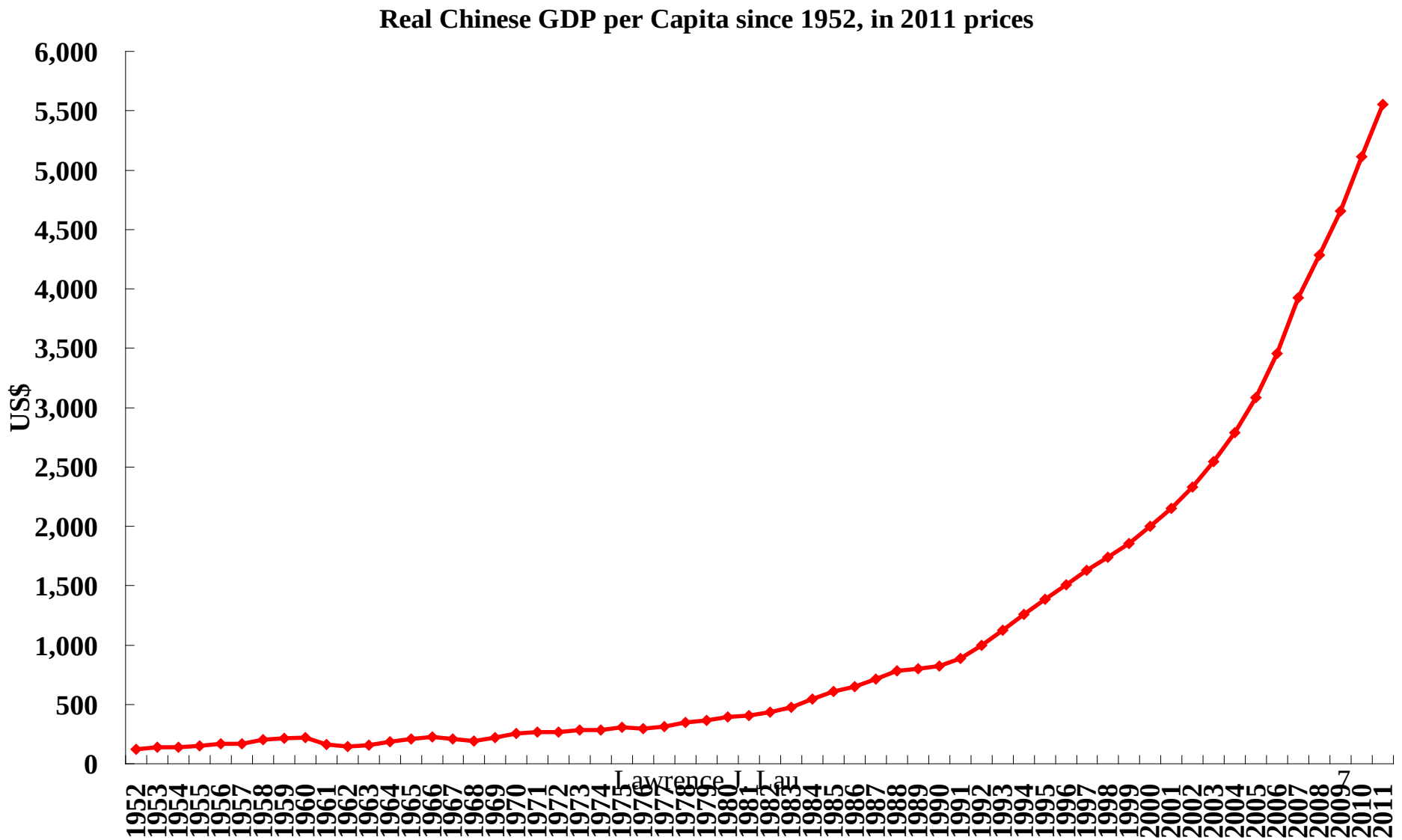
Chinese and U.S. Real GDP in US$ Since 1952 (2011 Prices)



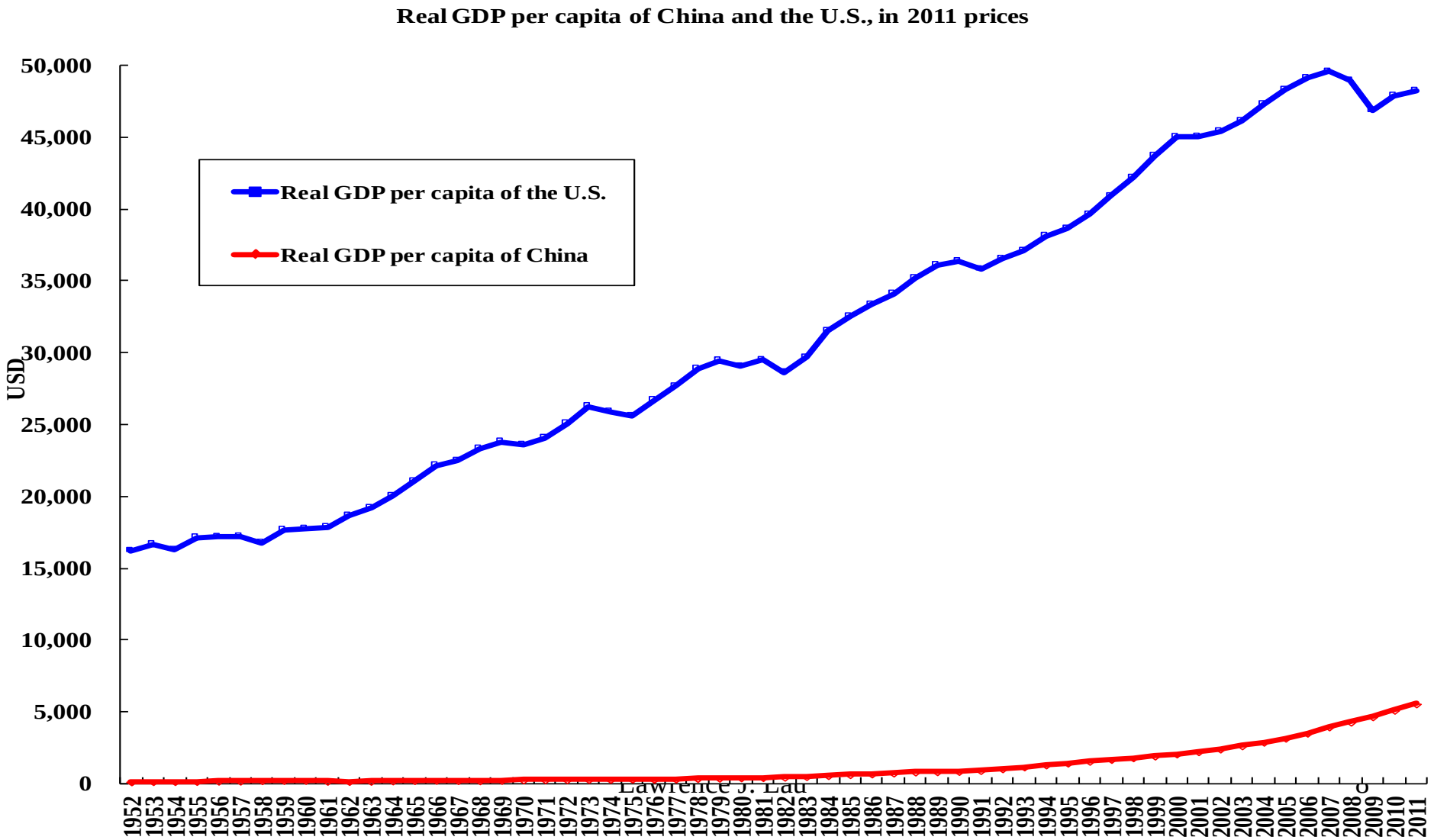
Introduction

- Despite its rapid growth, in terms of its real GDP per capita, China is still a developing economy.
- Between 1978 and 2011, Chinese real GDP per capita grew 15 times, from US$346 to US$5,555 (in 2011 prices). By comparison, the U.S. GDP per capita (approx. US$48,236) was 8.7 times Chinese GDP per capita in 2011.

Real Chinese GDP per Capita in US$ Since 1952 (2011 Prices)



Real Chinese and U.S. GDP per Capita in US$ Since 1952 (2011 Prices)



Introduction

- While many problems have arisen in the Chinese economy within the past decade—for example, increasing income disparity (both inter-regional and intra-regional), uneven access to basic education and health care, environmental degradation, inadequate infrastructure and corruption—it is fair to say that every Chinese citizen has benefited from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.

Introduction

- In the following table, the key performance indicators of the Chinese economy before and after the initiation of the economic reform and opening policy in 1978 are compared. It is readily apparent that there has been a huge improvement in every aspect of the economy—rates of growth of GDP, consumption, and international trade, on both an aggregate and per capita basis—except the average rate of inflation, which has become considerably higher in the period since 1978.

Key Performance Indicators Before and After Chinese Economic Reform

	Growth Rates percent per annum	
	Period I	**Period II**
	1952-1978	**1978-2011**
Real GDP	**6.15**	**9.89**
Real GDP per Capita	**4.06**	**8.78**
Real Consumption	**5.05**	**9.04**
Real Consumption per Capita	**2.99**	**7.94**
Exports	**9.99**	**17.32**
Imports	**9.14**	**16.63**
Inflation Rates (GDP deflator)	**0.50**	**4.24**

Introduction

- The Chinese Government leaders have also amply demonstrated their ability to confront important challenges and solve difficult problems over the past 34 years, surviving various economic and financial crises.
- China is one of the very few socialist countries that have made a smooth transition from a centrally planned to a market economy. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

The Shifting Centre of Gravity of the World Economy

- Through the past three decades, the centre of gravity of the World economy has been gradually shifting from the United States and Europe to Asia, including both East Asia and South Asia.
- The East Asian economies have become partially de-coupled from the rest of the World economy, as evidenced by the strong performance of China, India and other East Asian economies during the 2007-2009 global financial crisis as well as the current European sovereign debt crisis.
- However, the Chinese and East Asian economies are not large enough to turn the World around. The idea of a G-2 group of countries consisting of only China and the United States leading the World economy is premature.

The Economic Fundamentals

- Long-term economic growth of a country depends on the rates of growth of its primary inputs—(tangible or physical) capital and labour—and on technical progress (or equivalently the growth of total factor productivity)—that is, the ability to increase output without increasing inputs.
- The rate of growth of tangible capital depends on the rate of investment on structure, equipment and basic infrastructure, which in turn depends on the availability of national savings.
- The rate of technical progress depends on investment in intangible capital (principally human capital and R&D capital).

The Economic Fundamentals

- The most important source of Chinese economic growth over the past three decades has been the growth of inputs, principally tangible capital (structures, equipment, and basic infrastructure) and not technical progress. This experience is not unlike those of other East Asian economies such as South Korea and Taiwan and even Japan at a similarly early stage of economic development.
- However, unlike the experience of the other East Asian economies, economies of scale have played an important role in Chinese economic growth.
- The growth of tangible capital accounts for the bulk (more than 80%) of the measured economic growth in China. The tangible capital stock has been growing at approximately 15% per year.

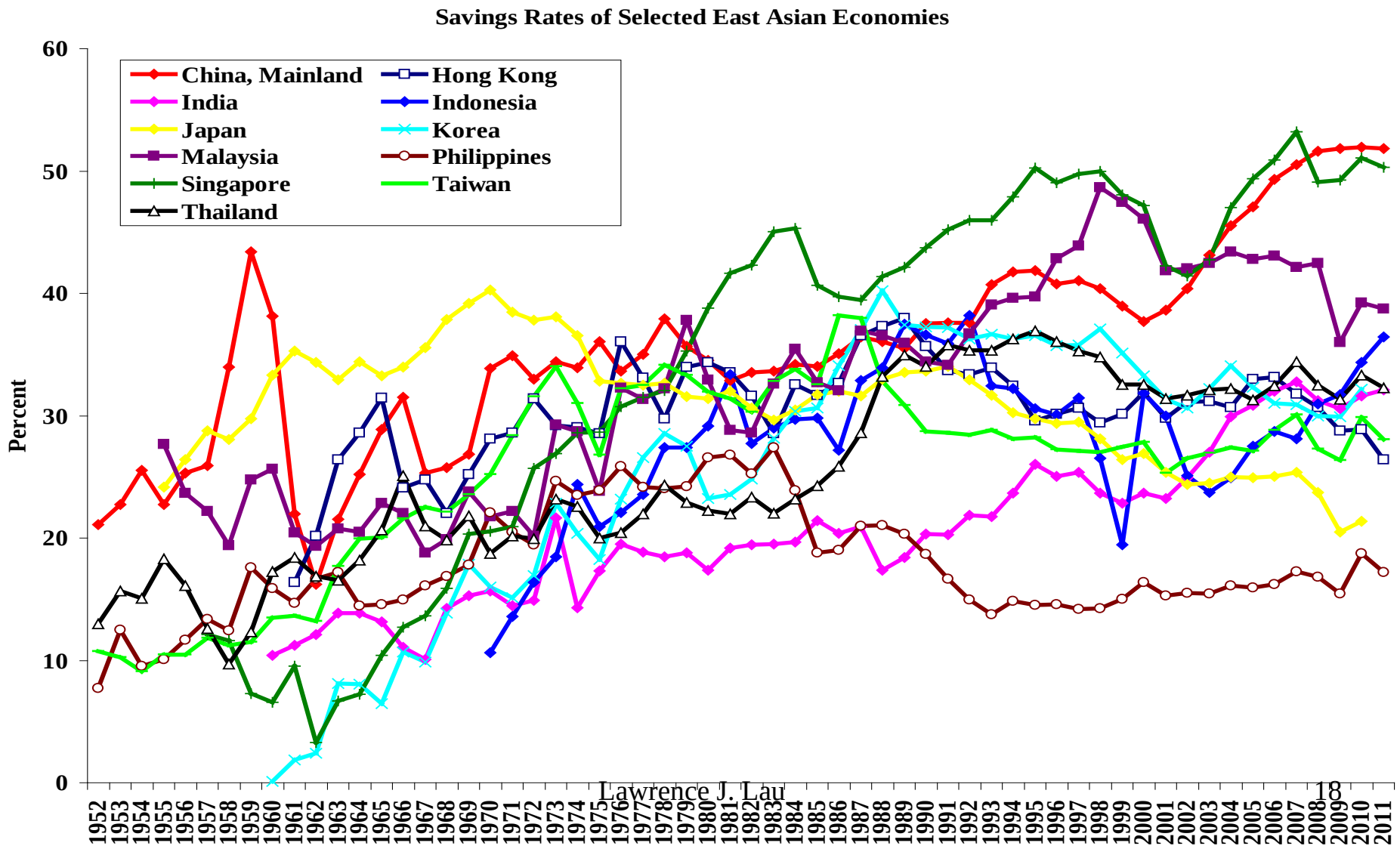
The Economic Fundamentals

- Chinese economic growth during the past 30 years has been underpinned by three factors:
- (1) A consistently high national savings rate on the order of 30% and above except for a short start-up period. It has stayed around 40% since the early 1990s and has at times approached or even exceeded 50% in more recent years. This means, among other things, that the Chinese economy can finance all of its domestic investment needs from its own domestic savings alone, thus assuring a high rate of growth of the tangible capital stock without having to depend on the more fickle foreign capital inflows (foreign portfolio investment, foreign direct investment or foreign loans).

The Economic Fundamentals

- (2) An unlimited supply of surplus labour—there is no shortage of and no upward pressure on the real wage rate of unskilled, entry-level labour. And
- (3) A huge domestic market of 1.34 billion consumers with pent-up demand for housing and transportation and other consumer goods and services (e.g., education and health care), enabling the realisation of significant economies of scale in production and in investment in intangible capital, including innovation and goodwill (e.g., brand building), based entirely on domestic demand. This is an advantage not available to the other East Asian economies.

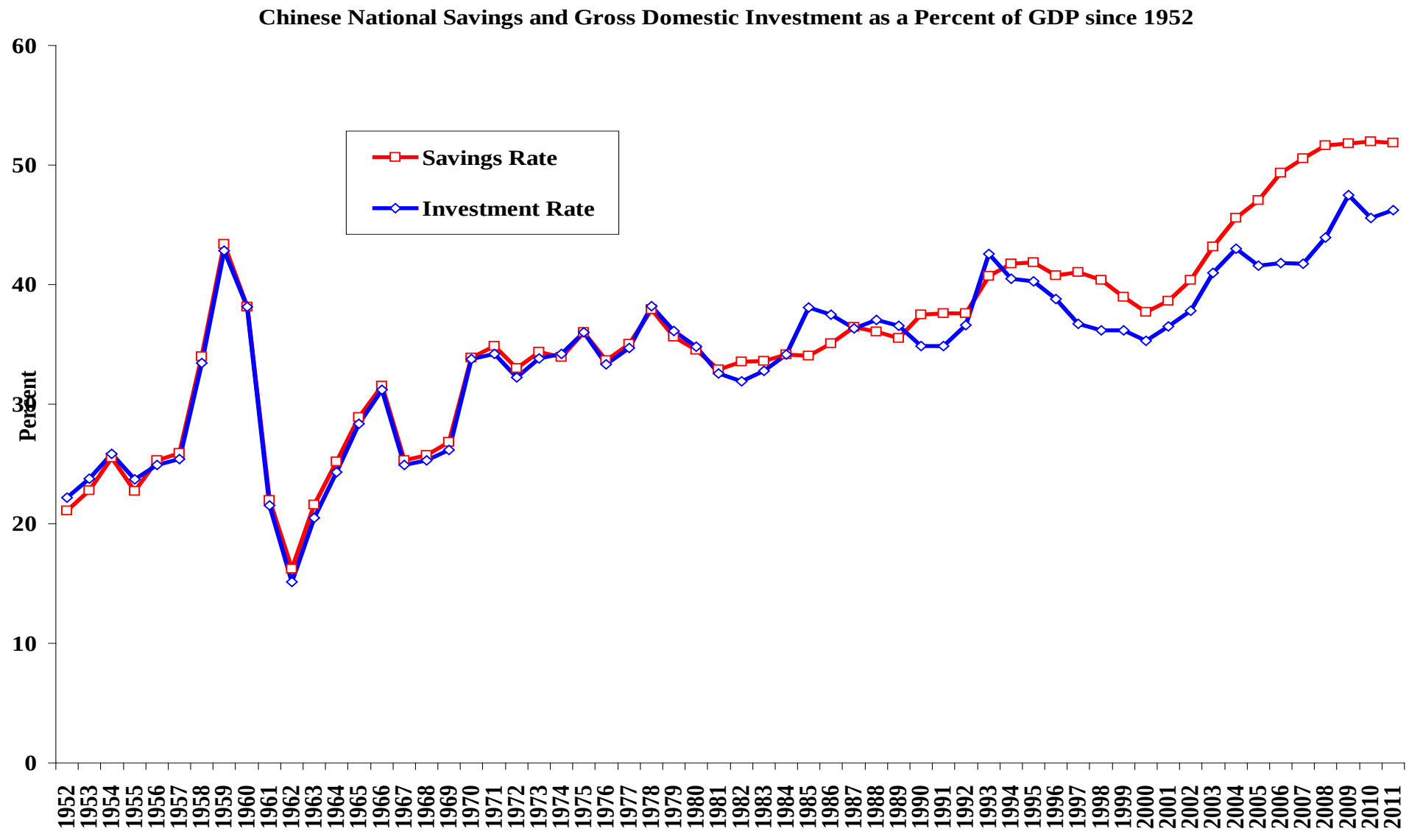
Savings Rates of Selected Asian Economies (1952-present)



The Economic Fundamentals

- China both saves too much and invests too much. However, the excessive savings and excessive investment were in approximate balance and thus there was little or no excess savings to be exported, and hence no trade surplus vis-a-vis the World, until 2005, when China began to have a trade surplus.
- Since 2008, the Chinese savings-investment gap has once again narrowed, resulting in a large reduction in the Chinese trade surplus relative to its GDP. The Chinese trade surplus has declined to 2% of its GDP by the end of 2011 and is expected to decline further during the next couple of years, reaching zero percent by perhaps 2015.

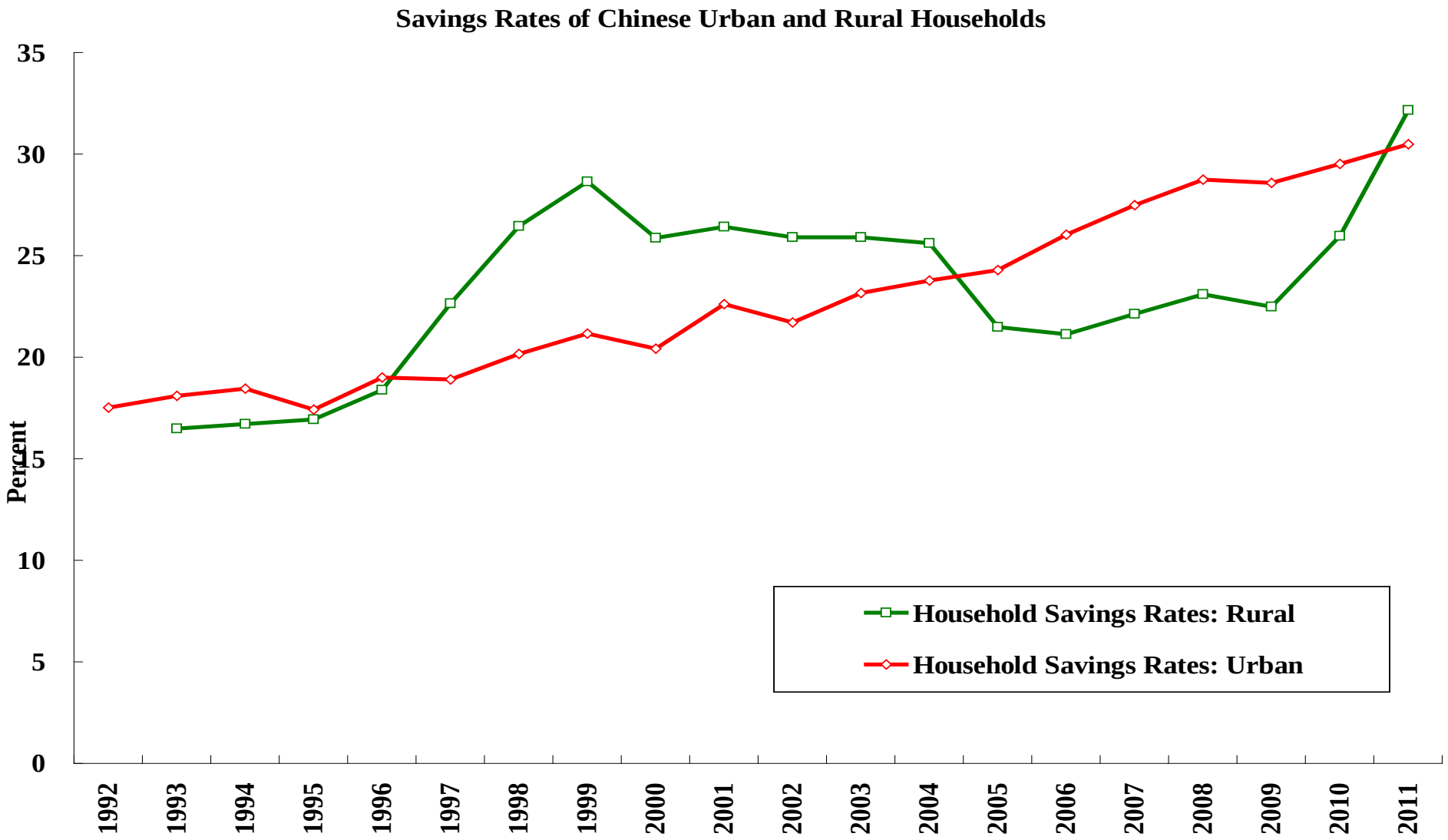
Chinese National Savings and Gross Domestic Investment as Percents of GDP



The Economic Fundamentals

- However, the high Chinese national savings rate is not due to an exceptionally high household savings rate. In fact, the Chinese household savings rate is not significantly different from those of ethnically Chinese households in Hong Kong and Taiwan, both market economies and where the social safety net is not completely adequate, particularly in Hong Kong. The high Chinese national savings rate is due to:
- (1) the lagged adjustment of household consumption to increases in household income because of the rapidity of the increases in the latter. It takes time for the growth of consumption to catch up to the growth of income. Thus, a high household savings rate is only transitory; it will settle down and stabilise as the rate of growth of household income reaches steady-state.
- (2) the much lower share of GDP received by households as income; in particular, the share of labor is low in China, currently less than 50% of GDP, compared to approximately 70% in the developed economies of the West.

Savings Rates of Urban and Rural Households



The Economic Fundamentals

- (3) the much higher Chinese corporate savings rates—Chinese enterprises, state-owned as well as non-state-owned, typically reinvest their earnings and distribute little or no cash dividends to their shareholders. Thus, the enterprise savings rate out of enterprise income (after taxes) is almost 100%.
- The high Chinese national savings rate is the result of a weighted average between the household savings rate and the high enterprise savings rate (with the government savings rate—the percentage budget surplus (deficit)—being basically insignificant).

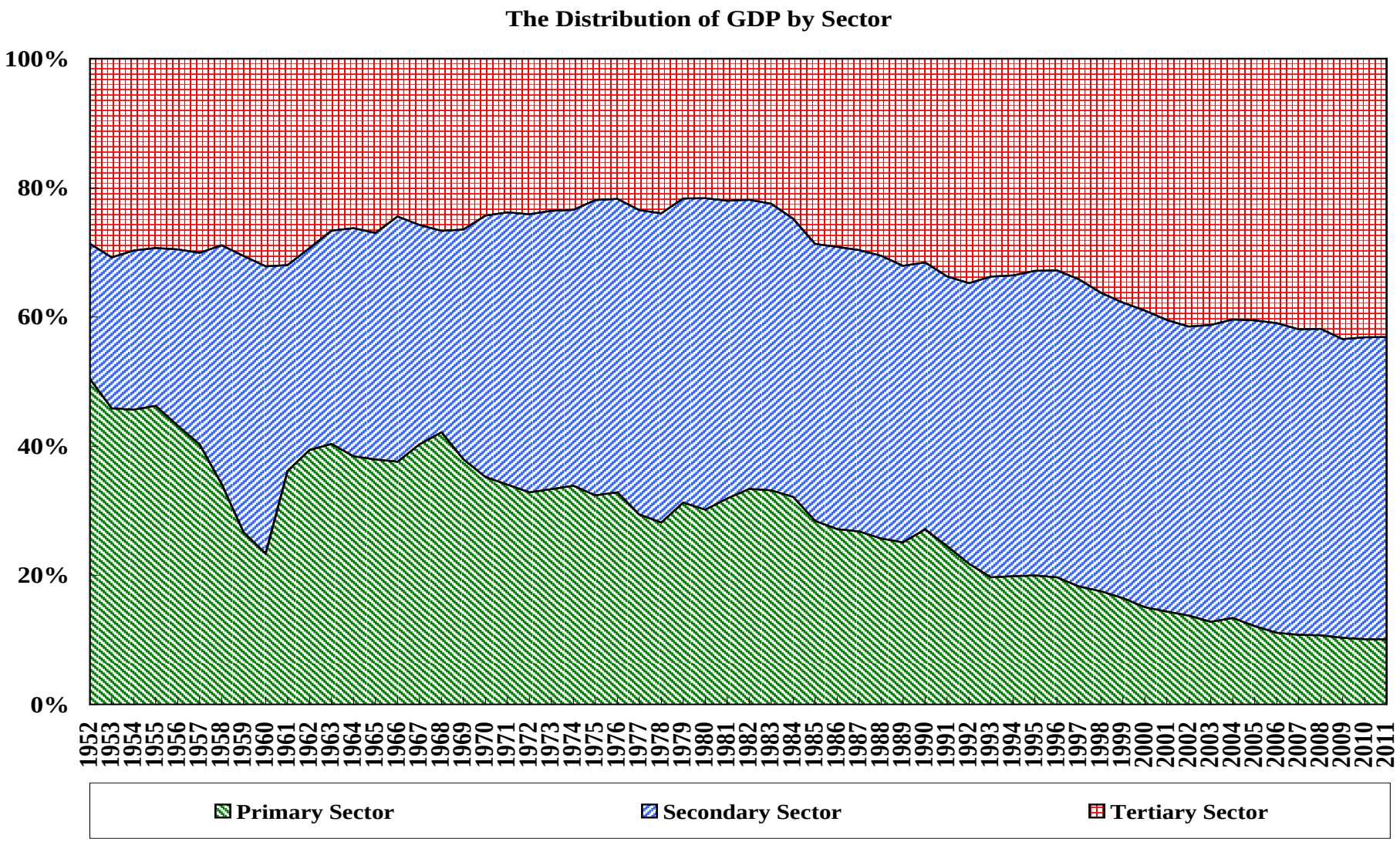
The Economic Fundamentals

- China, like Japan, Taiwan, and South Korea in their early stages of economic development, has an abundant supply of surplus labour. This means China can grow without being constrained by the supply of labour or by rising real wage rates of unskilled, entry-level labour over an extended period of time.
- Investment in physical capital is very productive under conditions of surplus labour and as long as there is sufficient complementary domestic physical capital, the surplus labour will enable the output of the economy to grow rapidly.
- This is exactly what the late Prof. W. Arthur Lewis, Nobel Laureate in Economic Sciences, said in his famous paper on surplus labour more than fifty years ago.

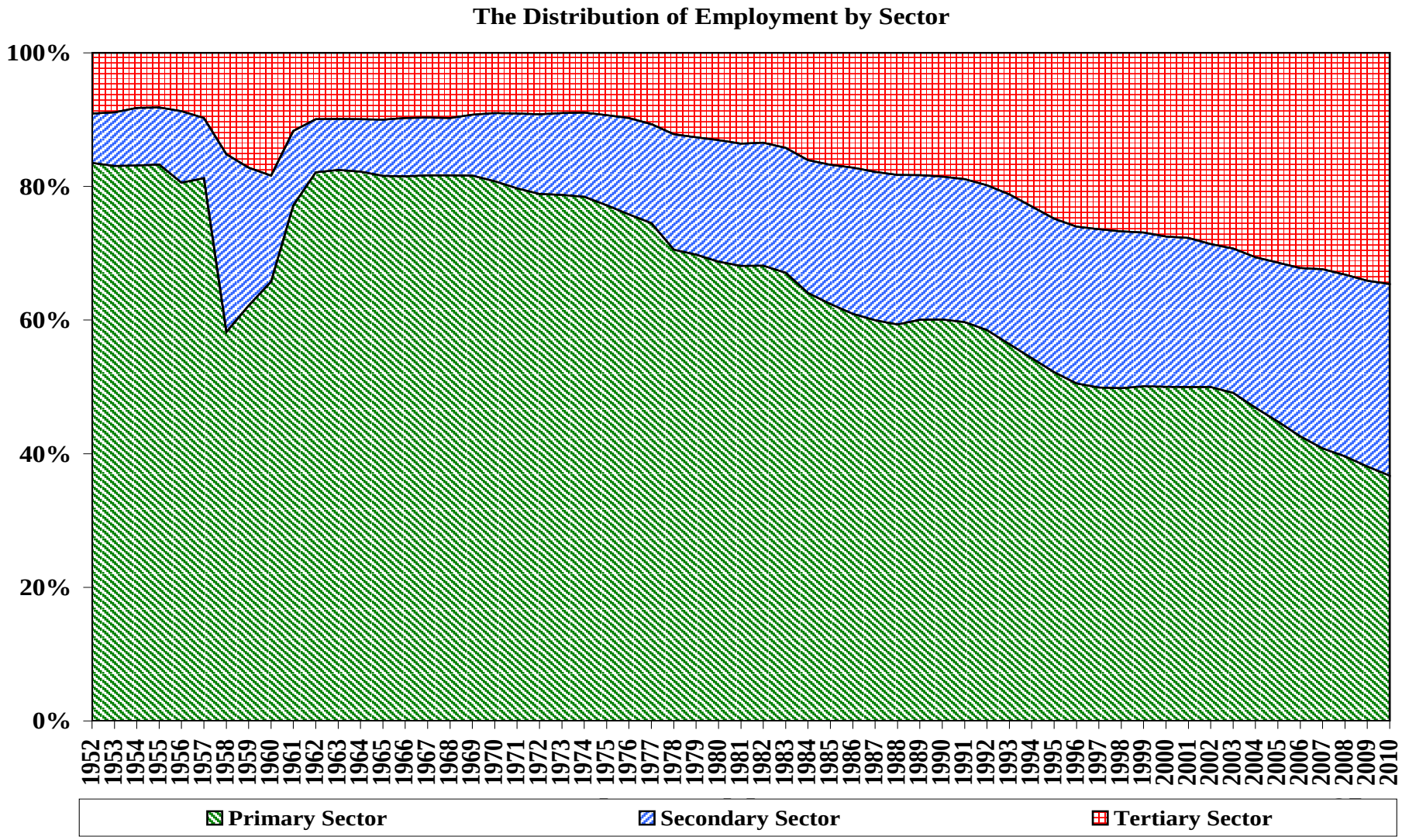
The Economic Fundamentals

- The distribution of Chinese GDP by originating sectors in 2011 was approximately: Primary (agriculture), 10.1%; Secondary (manufacturing, mining and construction), 46.8%; and Tertiary (services), 43.1%. (Note that mining is normally included in the primary sector in most other economies.)
- But the bulk of the labour force, more than 36%, is still employed in the primary sector, which in the case of China consists of only agriculture, waiting to be transferred to the other two sectors which have higher productivity.
- As long as the percentage of labour force employed in the primary sector significantly exceeds the percentage of GDP originating from the primary sector, there is little or no upward pressure on the real wage rate of unskilled, entry-level labour in the secondary and tertiary sectors.

The Distribution of Chinese GDP by Sector Since 1952



The Distribution of Chinese Employment by Sector Since 1952



The Economic Fundamentals

- It took thirty-three years for the percentage of labour force employed in the Chinese primary sector to decline from 70.5% in 1978 to its current 36.7%, at the rate of approximately 1 percentage point per year.
- It will take approximately another 25 years or so for the percentage of labour force employed in the Chinese primary sector to decline from its current 36.7% to below 10%, which is approximately the same as the percentage of Chinese GDP produced by the primary sector today. By that time, it is expected that the primary sector will account for no more than 5% of Chinese GDP.
- China will therefore continue to have surplus labour for another two or three decades or even longer. There will not be any shortage of unskilled, entry-level labour for a long time to come, even though there may be shortages of skilled or experienced labour in the secondary and tertiary sectors.

The Economic Fundamentals

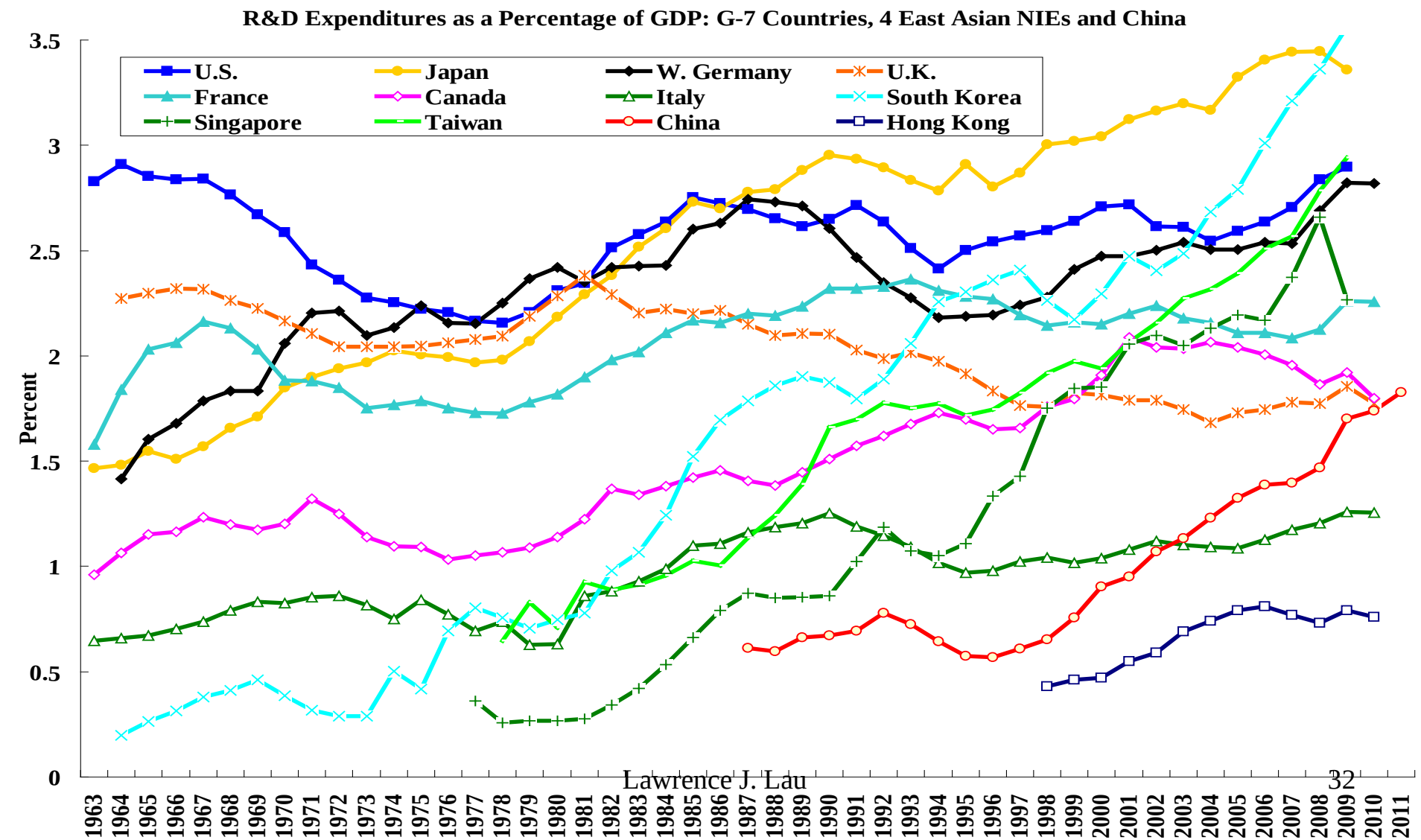
- China also has a long tradition of emphasis on education and learning (human capital) and will be increasing its investment in human capital. The enrollment rate of tertiary education has been rising rapidly and stands at 24 percent today. It is expected to rise further over the next three decades as private tertiary educational institutions become more numerous in response to demand and facilitated by government policy.

The Economic Fundamentals

- Sustained investment in research and development (R&D) is essential for technical progress in an economy. China has also begun to invest heavily in R&D in recent years--R&D expenditure has been rising rapidly, both in absolute value, and as a percentage of GDP, but still lags behind the developed economies as well as the newly industrialised economies of East Asia. (The Chinese R&D Expenditure/GDP ratio is targeted to reach 2.5% in 2015, still below the historical average for the U.S.)
- By comparison, both Japan and South Korea invest more than 3% of their GDPs in R&D annually. The United States has on average invested almost 3% of its GDP in R&D since the late 1950s.

China's R&D Expenditure and Its Share of Chinese GDP

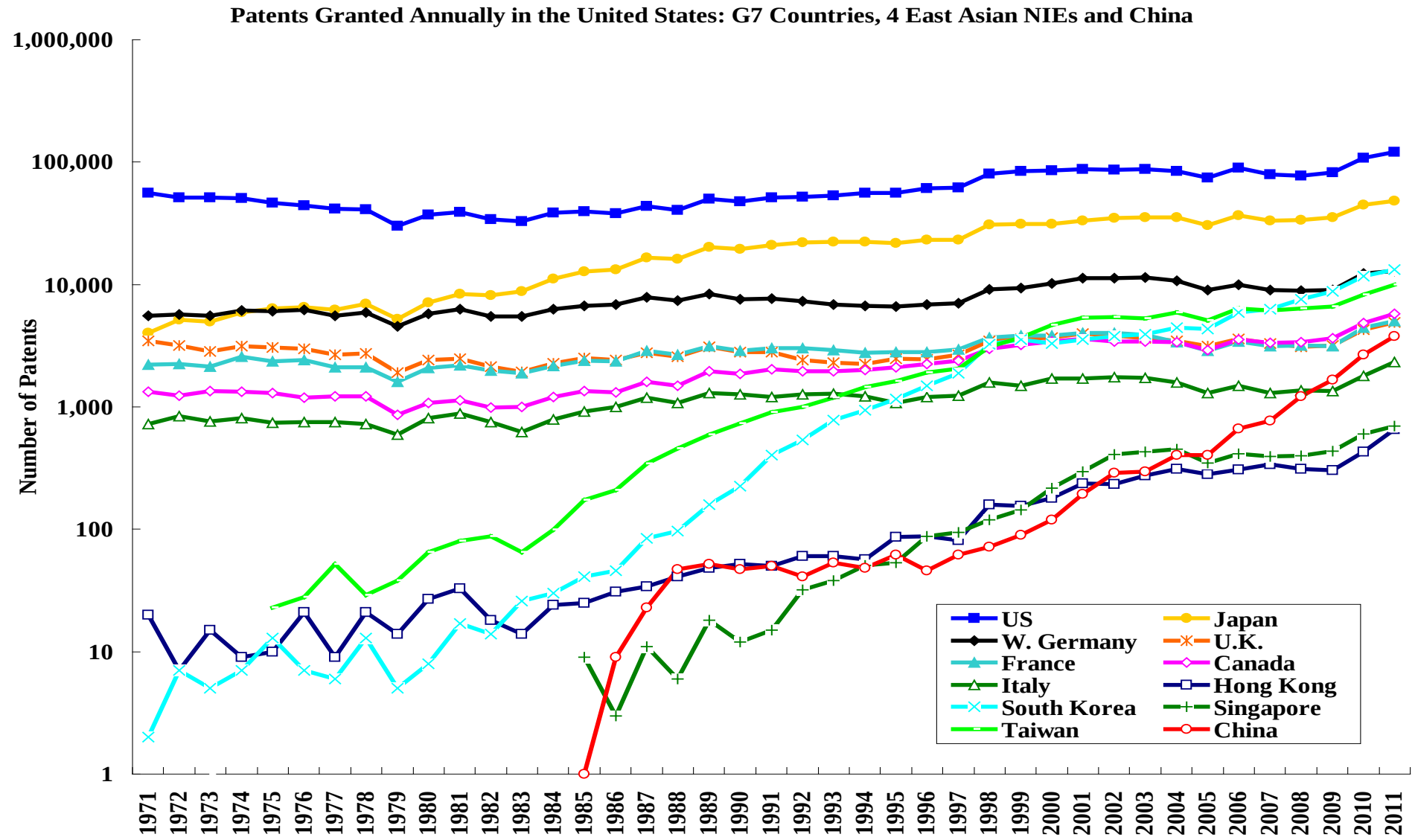
R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIES & China



The Economic Fundamentals

- One indicator of the potential for technical progress (national innovative capacity) is the number of patents created each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented. The U.S. is the undisputed champion over the past forty years, with close to 100,000 patents granted each year, followed by Japan. (Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries, the comparison across them should be fair.)
- The number of patents granted to Chinese applicants each year has increased from 1 in 1985 to 3,786 patents in 2011.
- South Korea and Taiwan are still ahead of China in terms of the number of patents granted in the U.S., averaging approximately 10,000 patents a year each.

Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China

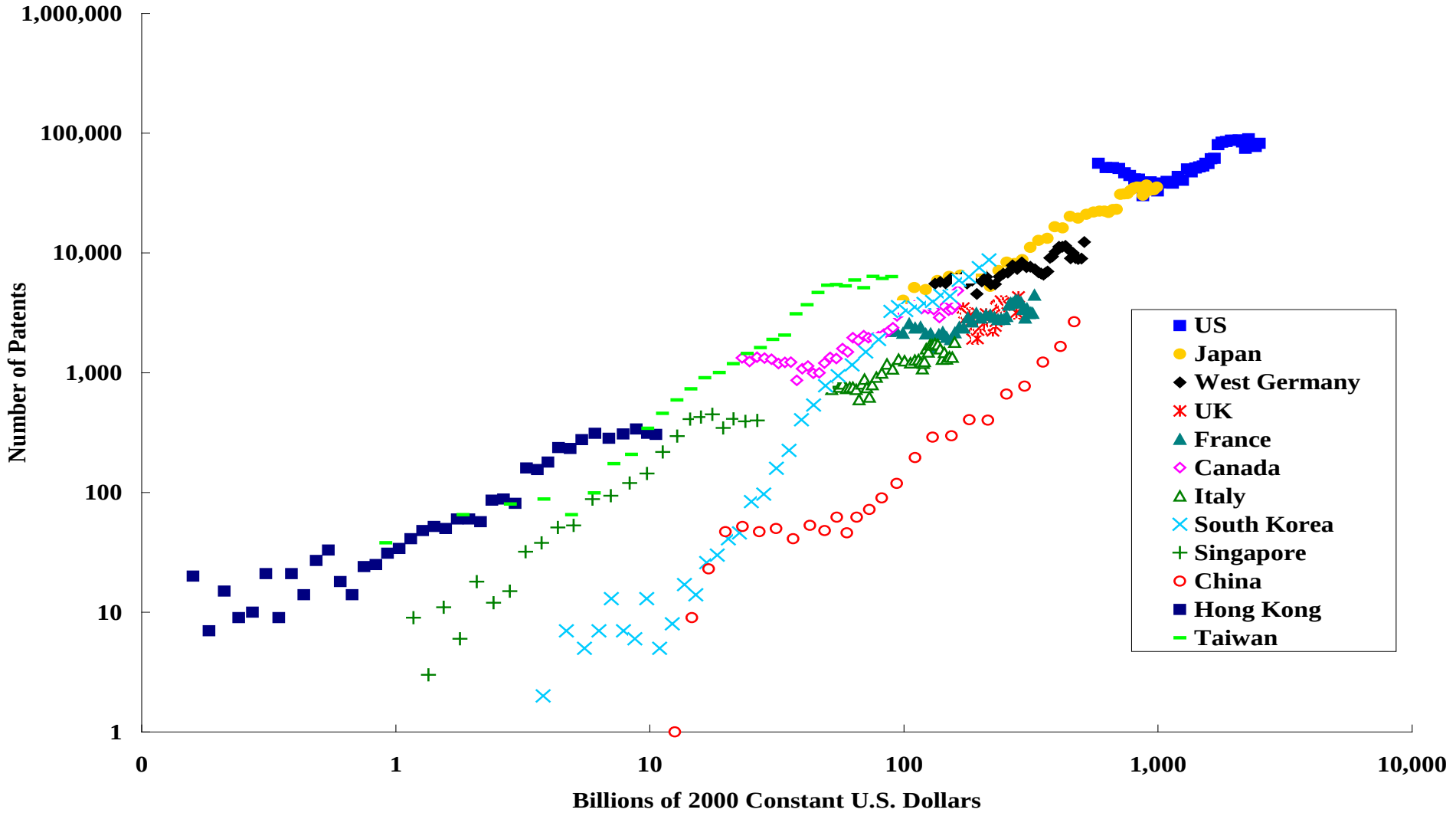


The Economic Fundamentals

- The stock of R&D capital, defined as the cumulative past real investment in R&D less depreciation of 10% per year, can be shown to have a direct causal relationship to the number of patents granted (see the following chart, in which the number of patents granted is plotted against the R&D capital stock for each country and each year).
- Because China has had both a much lower R&D investment to GDP ratio and a much lower GDP than the United States and other developed economies in the past, it will take more than a couple of decades before Chinese R&D capital can catch up to the level of U.S. R&D capital (and hence to the number of patents granted each year).
- Chinese efficiency in the generation of patents in the U.S. also lags behind the other East Asian newly industrialised economies in terms of the number of patents granted for given levels of the stock of R&D capital.

Patents Granted in the United States and R&D Capital Stocks, Selected Economies

Figure 8.4: The Number of U.S. Patents Granted Annually vs. R&D Capital Stocks



The Economic Fundamentals

- The huge potential domestic market of 1.34 billion consumers not only enables the realisation of economies of scale but also greatly enhances the productivity of intangible capital (e.g., R&D capital, goodwill). The fixed research and development costs of a new product or process can be easily amortised over a large market. The benefits of investment in goodwill, e.g., brand-building, are also much greater in a large market.
- The huge potential domestic market also enables active Chinese participation in the setting of product and technology standards and sharing the benefits of such standard-setting.
- Brand-building is a pre-requisite for Chinese enterprises to re-orient themselves to take advantage of the huge domestic market. It is true that brand-building requires resources, but it also enables the owners of brand names to have much more pricing power and higher profit margins than enterprises that do only OEM (original equipment manufacturing) business.

The Economic Fundamentals

- In addition to a high national savings rate, a large pool of surplus labour, a huge domestic market, and rising investment in intangible capital (human capital and R&D capital), China also has the advantage of relative backwardness:
  - The ability to learn from the experiences of successes and failures of other economies;
  - The ability to leap-frog stages of development (e.g., the telex machine, the VHS video players, the fixed landline phones); and
  - The possibility of creation without destruction (e.g., online virtual bookstores like Amazon.com do not have to destroy brick and mortar bookstores which do not exist in the first place).
- An abundance of scientific and technical manpower the cost of which is a fraction of the cost in developed economies.

The Metaphor of the "Wild Geese Flying Pattern"

- The metaphor of the "wild-geese-flying pattern" of East Asian economic development over time (Kaname Akamatsu (1962)) suggests that industrialisation will spread from economy to economy as the initially fast-growing economies, beginning with Japan, run out of surplus labour and face labour shortages, rising real wage rates, and quota restrictions on their exports.
- Thus East Asian industrialisation spread from Japan to first Hong Kong, and then Taiwan, and then South Korea, and then Southeast Asia (Thailand, Malaysia, Indonesia), and then to Guangdong, Shanghai, Jiangsu and Zhejiang in Mainland China. During this industrial migration, the large trading firms such as Mitsubishi, Mitsui, Marubeni and Sumitomo of Japan and Li and Fung of Hong Kong played an important role as financiers, intermediaries and managers of logistics and supply chains.

The Metaphor of the "Wild Geese Flying Pattern"

- This metaphor applies not only to East Asia but also to China itself. Within China, industrialisation has begun first in the coastal provinces, regions and municipalities. It has begun to migrate and spread to other provinces, regions and municipalities in the interior—to Chongqing, Henan, Hunan, Jiangxi and Shaanxi. As the coastal provinces, regions and municipalities slow down in their economic growth, the central and western provinces, regions and municipalities will take their turn as the fastest growing areas in China. China as a whole will be able to maintain its high rate of growth for many years to come.

The Metaphor of the "Wild Geese Flying Pattern"

- However, the economies of the Chinese coastal regions such as the Pearl River Delta (Guangdong Province) and the Yangzi River Delta (Jiangsu and Zhejiang Provinces and Shanghai Municipality) would have slowed down a long time ago had it not been for the migrant labourers that flocked to these regions from the interior, constantly replenishing the supply of surplus labour there.

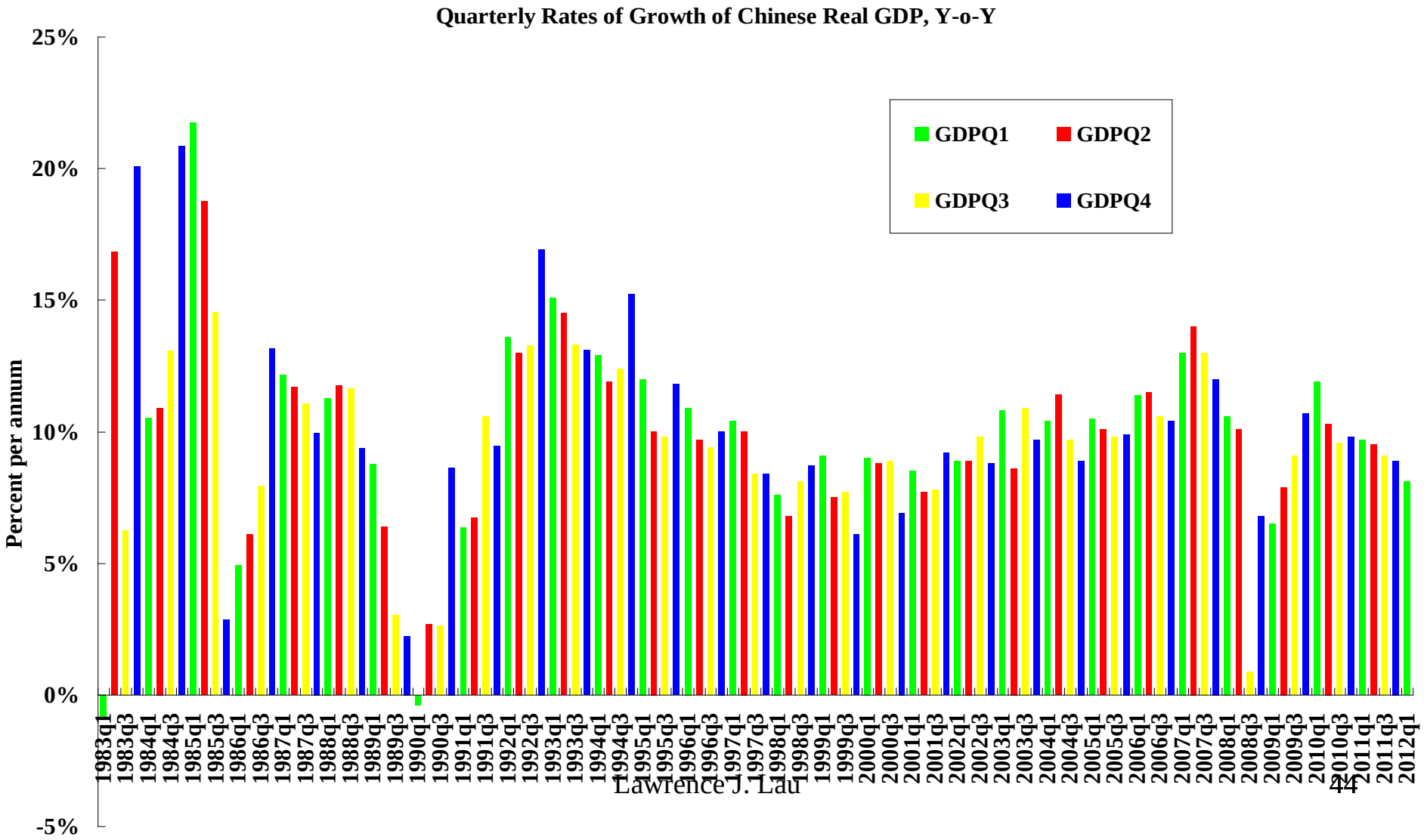
The Macroeconomic Outlook

- The Chinese economy has survived the East Asian currency crisis of 1997-8, the global financial crisis of 2007-9 as well as the currently on-going European sovereign debt crisis relatively unscathed.
- The 4-trillion Yuan economic stimulus package launched by the Chinese Government in November 2008, barely six weeks after the bankruptcy of Lehman Brothers, has been quite effective in sustaining the confidence and positive expectations of the future of Chinese enterprises and households to continue investing and consuming and thereby maintaining Chinese economic growth despite the economic turmoil in the United States and Europe.

The Macroeconomic Outlook

- The Chinese economy grew 9.2% in 2009, 10.4% in 2010 and 9.2 % in 2011 even as the European and U.S. economies remained in recession.
- The outlook is that there will be a gradual slowdown in the real rate of growth of the economy in 2012, to perhaps around 8%, which is actually a positive development for the Chinese economy. The official target growth rate for the year, announced by Premier WEN Jiabao at the National People's Congress, is 7.5%. The official target average growth rate for the Twelfth Five-Year Plan (2011-2015) period is a relatively modest 7%.

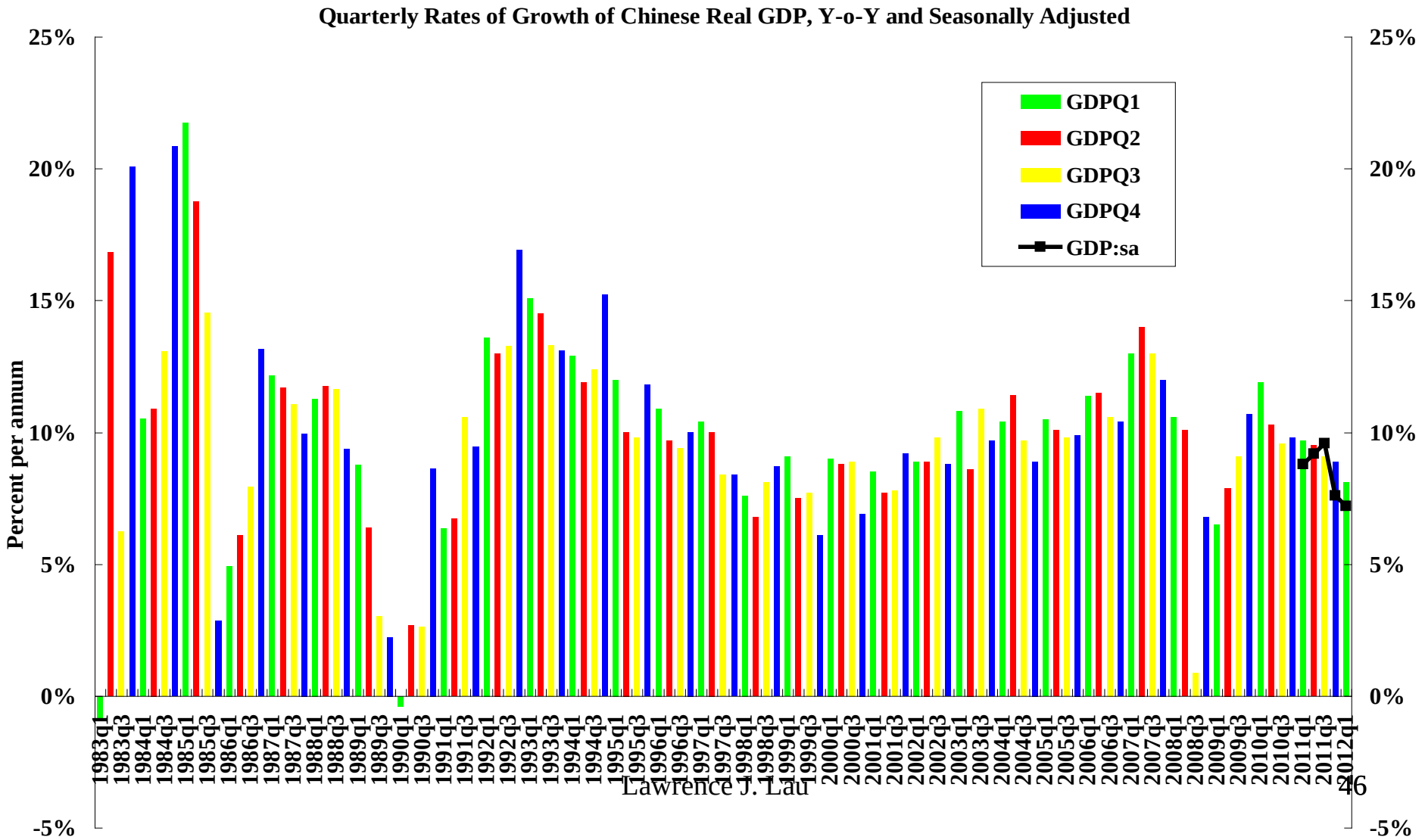
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y



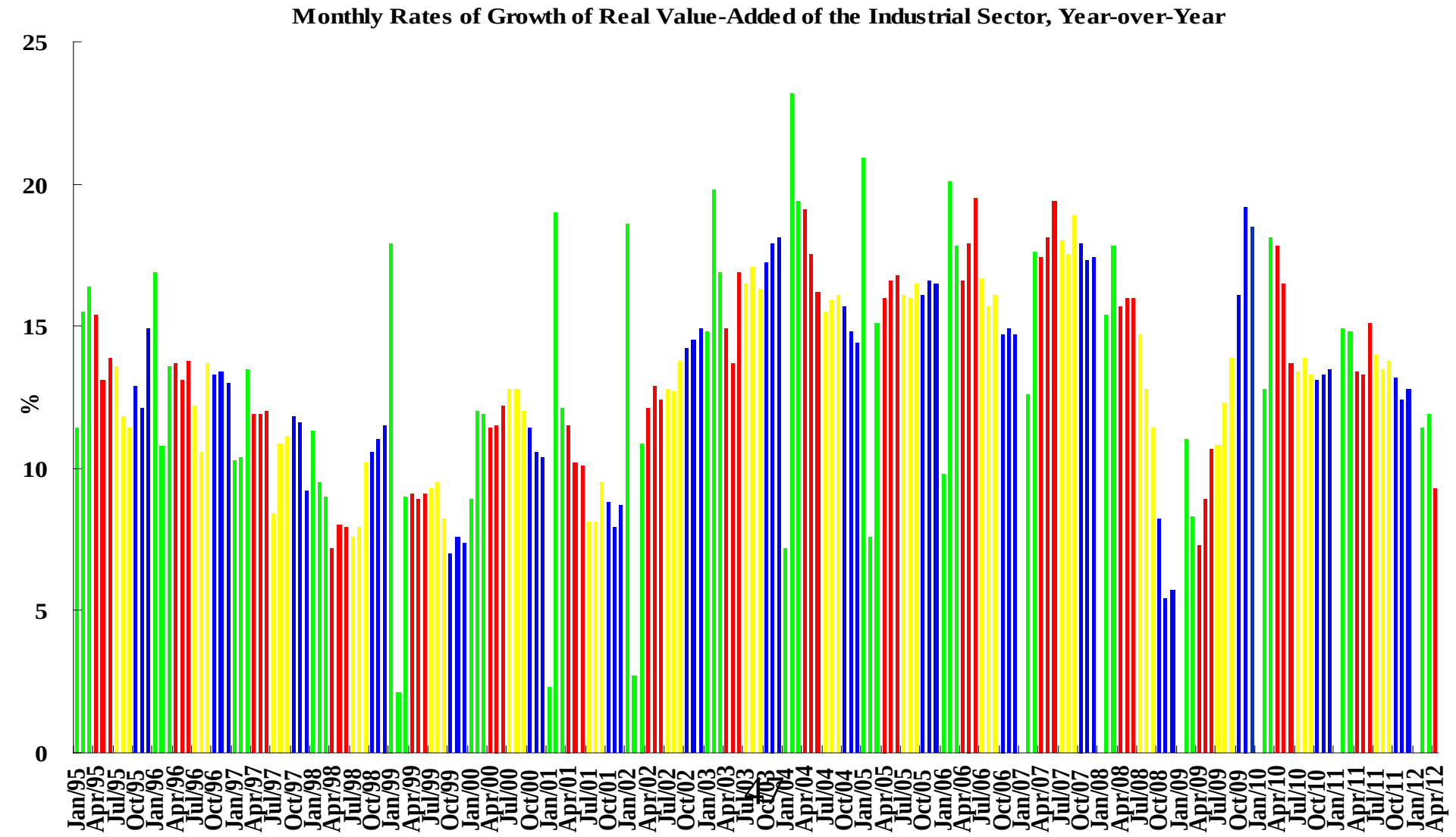
The Macroeconomic Outlook

- In 2012Q1, the rate of growth of real GDP was 8.1%, Y-o-Y and 7.2% per annum, seasonally adjusted.
- While 7.2% may seem like a significant reduction from 9.2%, there are reasons to believe that the impact of the economic slowdown on Chinese employment is not that severe.
- However, 7.5% growth for the year 2012 is certainly achievable. The recent slowdown in the Chinese economy is due, in part to the continued weakness in exports to the United States and Europe, and in part, to the change in the inventory behaviour of importers in the United States and Europe, and in part to the political uncertainty surrounding the once-in-a-decade political transition.

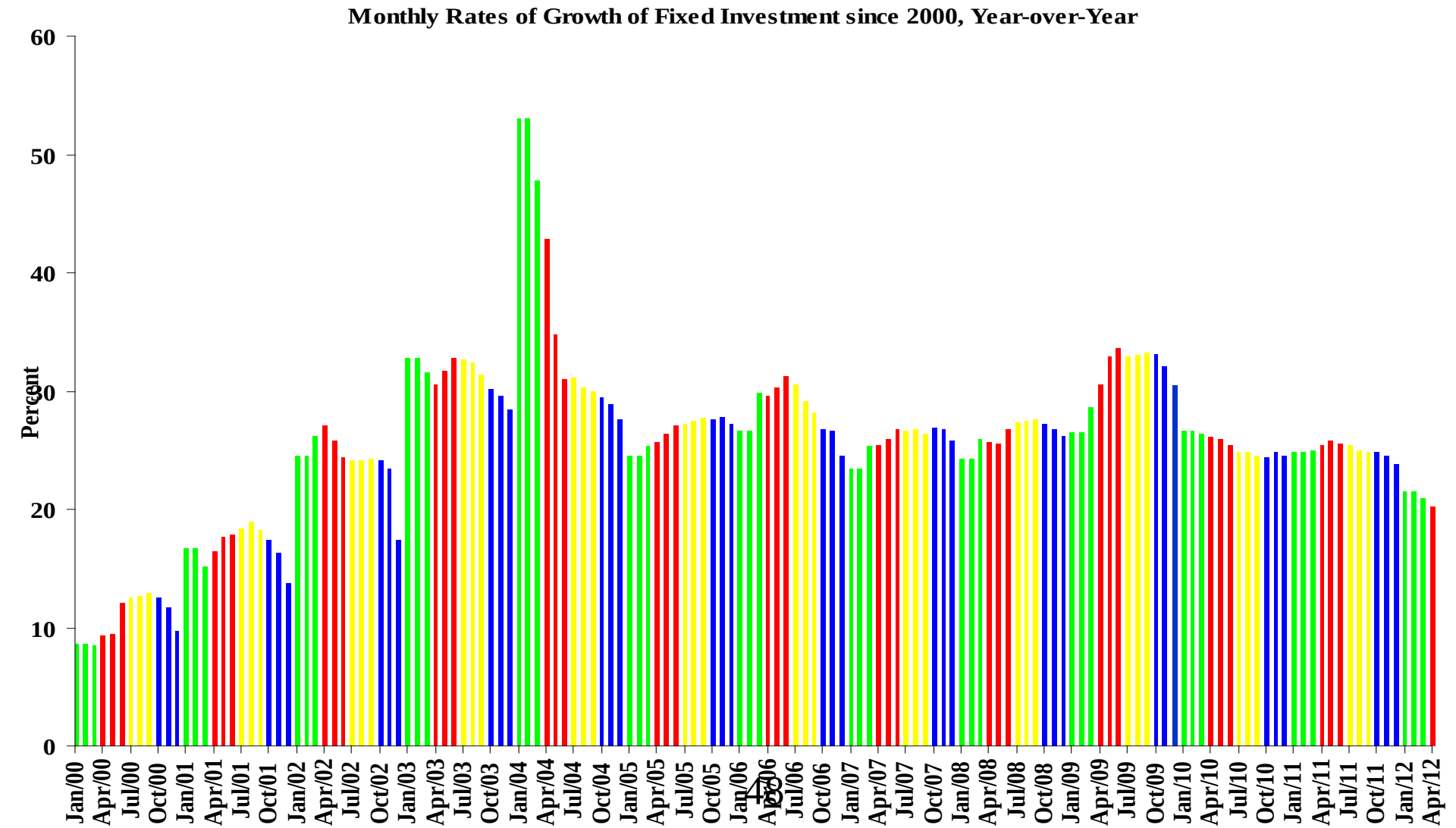
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y and Seasonally Adjusted



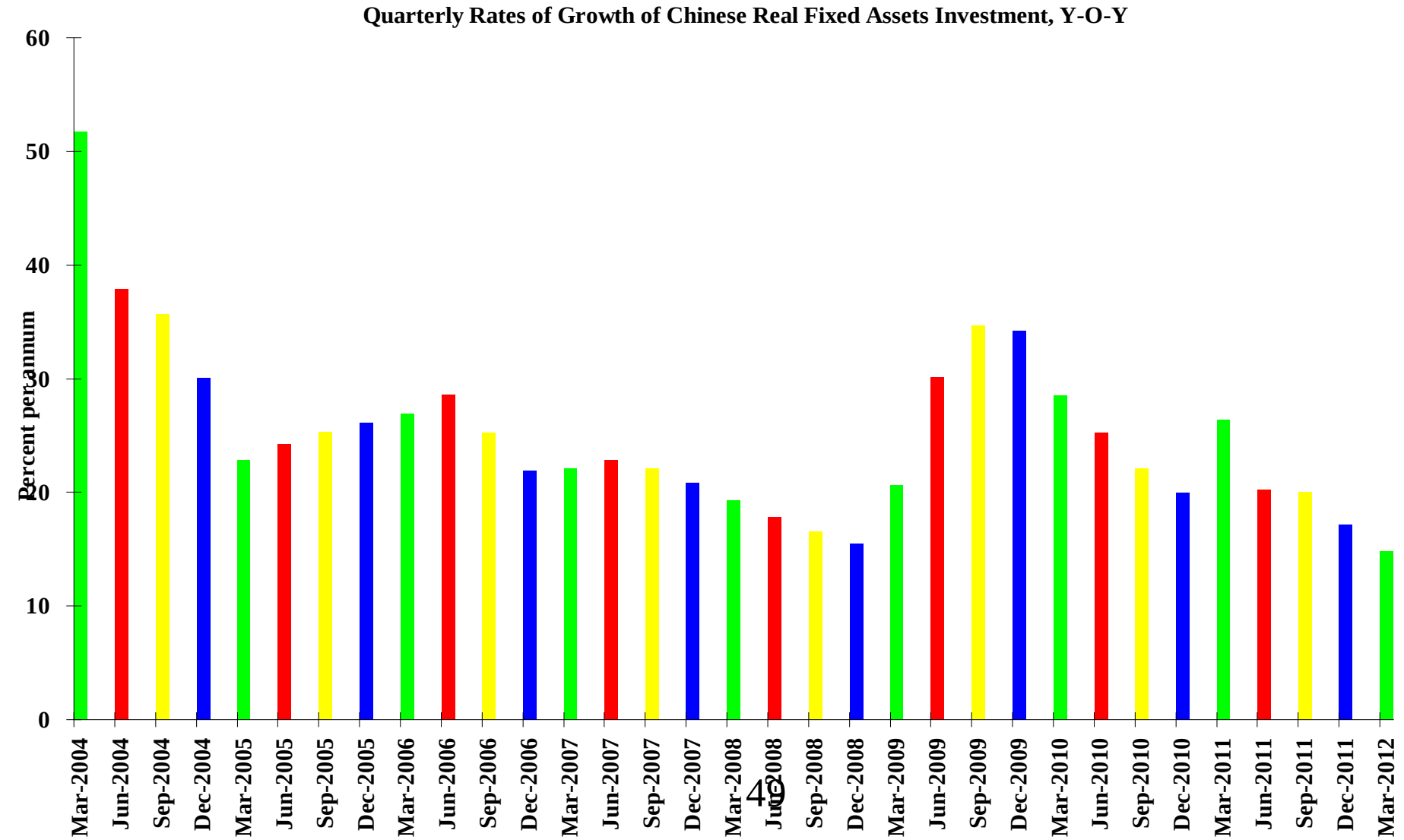
Monthly Rates of Growth of Real Value-added of the Industrial Sector, Y-o-Y



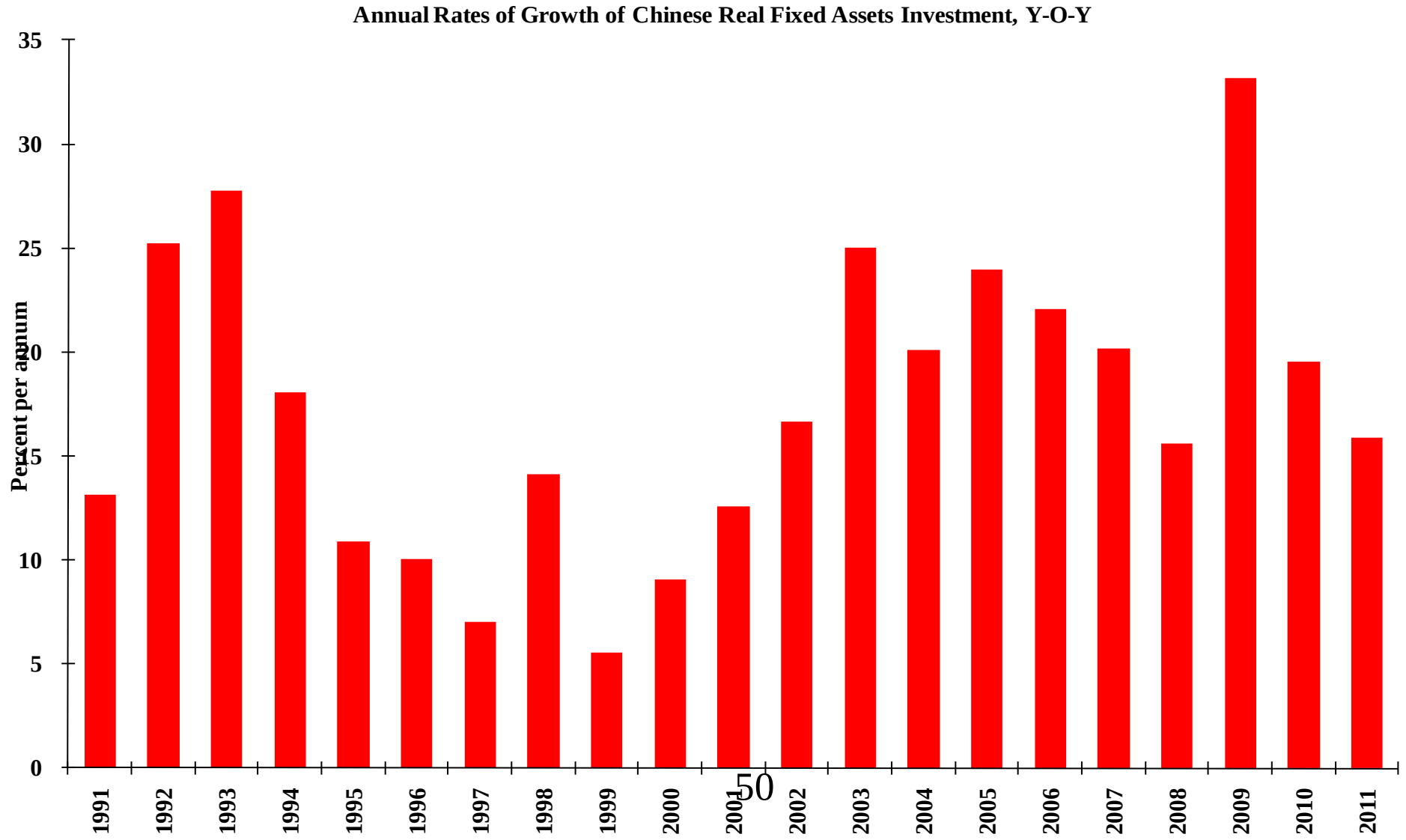
Monthly Rates of Growth of Chinese Fixed Assets Investment, Y-o-Y



Quarterly Rates of Growth of Chinese Real Fixed Assets Investment, Y-O-Y



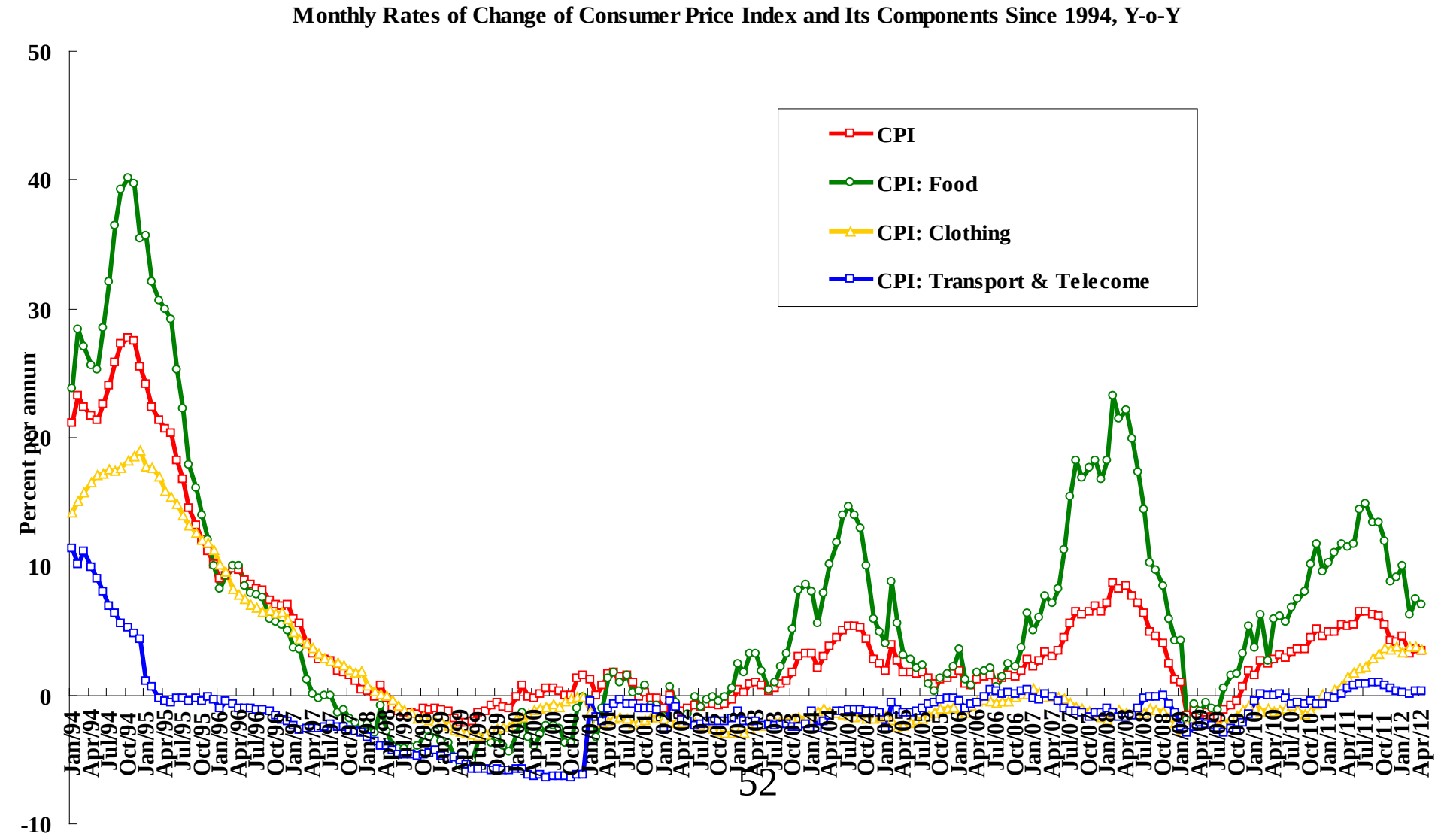
Annual Rates of Growth of Chinese Real Fixed Assets Investment, Y-O-Y



The Macroeconomic Outlook

- The rate of inflation of goods and services, as measured by the consumer price index (CPI), rose during the first half of 2011, reaching a peak of 6.5% year-over-year in June, and then decreased in the second half of the year. as the rate of growth of agricultural prices declined. For 2011 as a whole, the rate of inflation exceeded the objective of the Chinese Government of 4%, at 5.4%, an increase from the 3.3% of 2010.
- The rates of inflation as measured by the CPI were 4.5%, 3.2%, 3.6% and 3.4% for the first four months of 2012 respectively. Seasonally adjusted, they were, at annual rates,18%, -1.2%, 2.4% and -1.2% respectively.
- The government target for 2012 is to keep the rate of inflation to below 4%, which appears feasible at this time.

Monthly Rates of Change of the Consumer Price Index (CPI), Y-o-Y



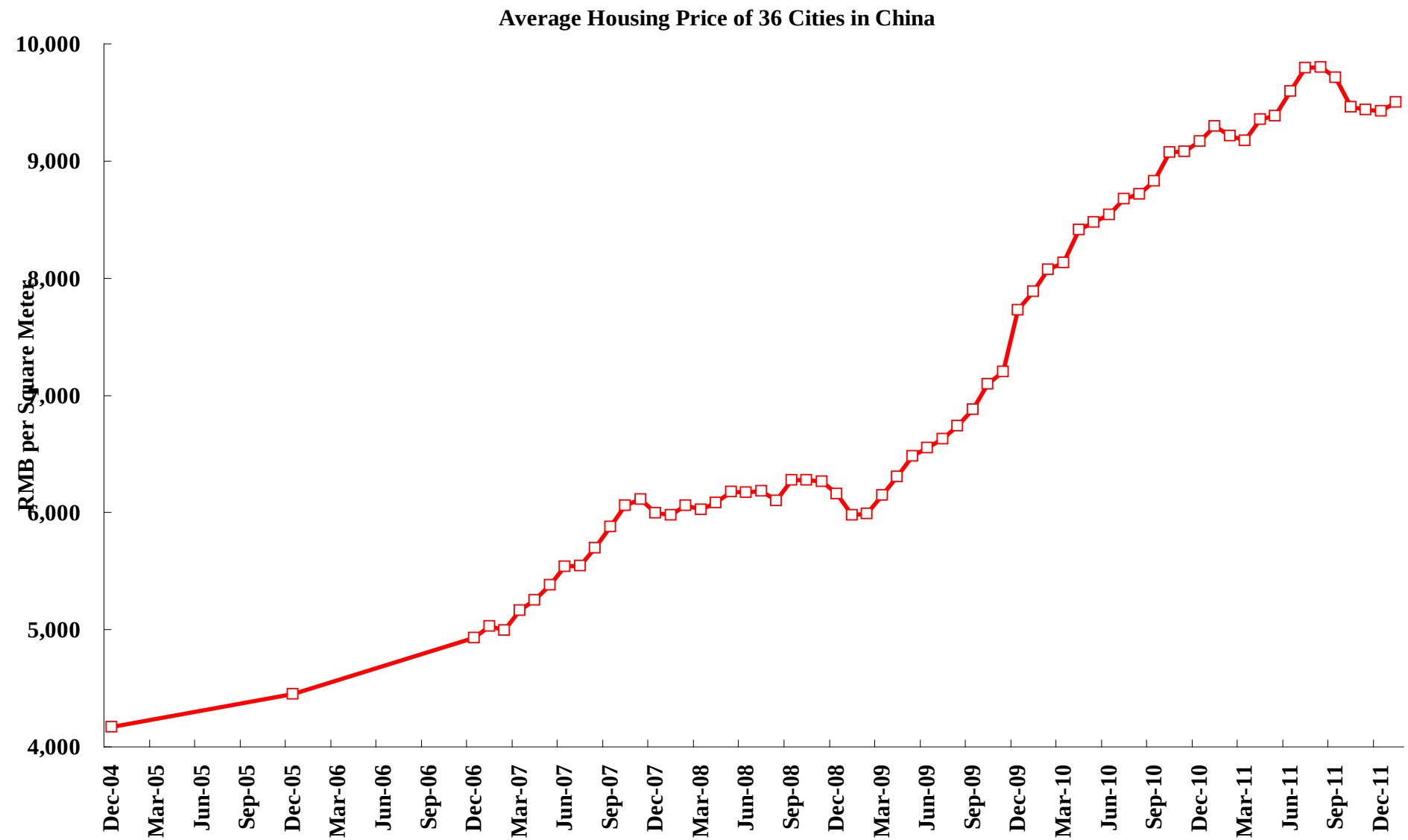
The Macroeconomic Outlook

- However, it should be noted that the bulk of the increase in the consumer price index (approximately 70%) was caused by the increase in food prices (principally the prices of pork and vegetables), due mostly to weather and the natural production cycle and possibly hoarding and market manipulation and not to monetary factors.
- The core rate of inflation, that is, the rate of inflation net of the changes in the prices of agricultural and energy goods, has remained relatively tame, below 2% per annum level, as has been the case in the past few years.
- Moreover, given the excess production capacity in many key industries, such as steel, cement, and glass, it is unlikely that there will be much inflation in the prices of non-agricultural goods in the next couple of years.

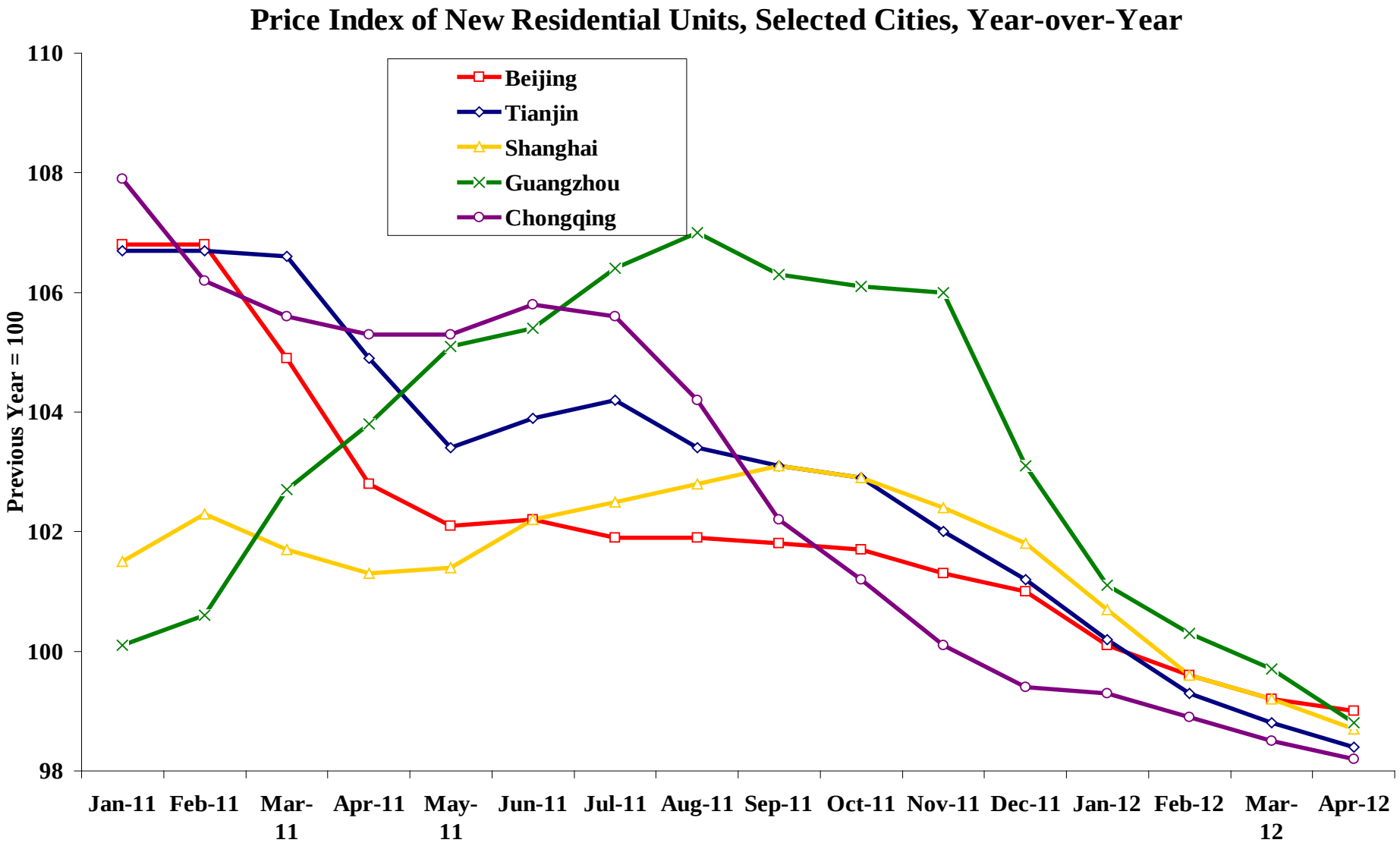
The Macroeconomic Outlook

- However, there has been significant inflation in the prices of assets such as real estate in the past year or two due to the implementation of the economic stimulus package and the significant increases in the rates of growth of money supply and commercial bank credit.
- Measures have been taken recently to contain the asset price bubble. State-owned enterprises that have not been explicitly authorised are now forbidden to invest in real estate. Bank lending rules have also been tightened so as to discourage the purchases of more than one residential unit by a single household. Recently, the People's Bank of China, the central bank, after increasing the rates of interest (the minimum lending rate and the maximum deposit rate) and the reserve requirement ratio repeatedly, has begun to reduce them.
- The rates of growth of money supply (both M1 and M2) and loans have also declined significantly.

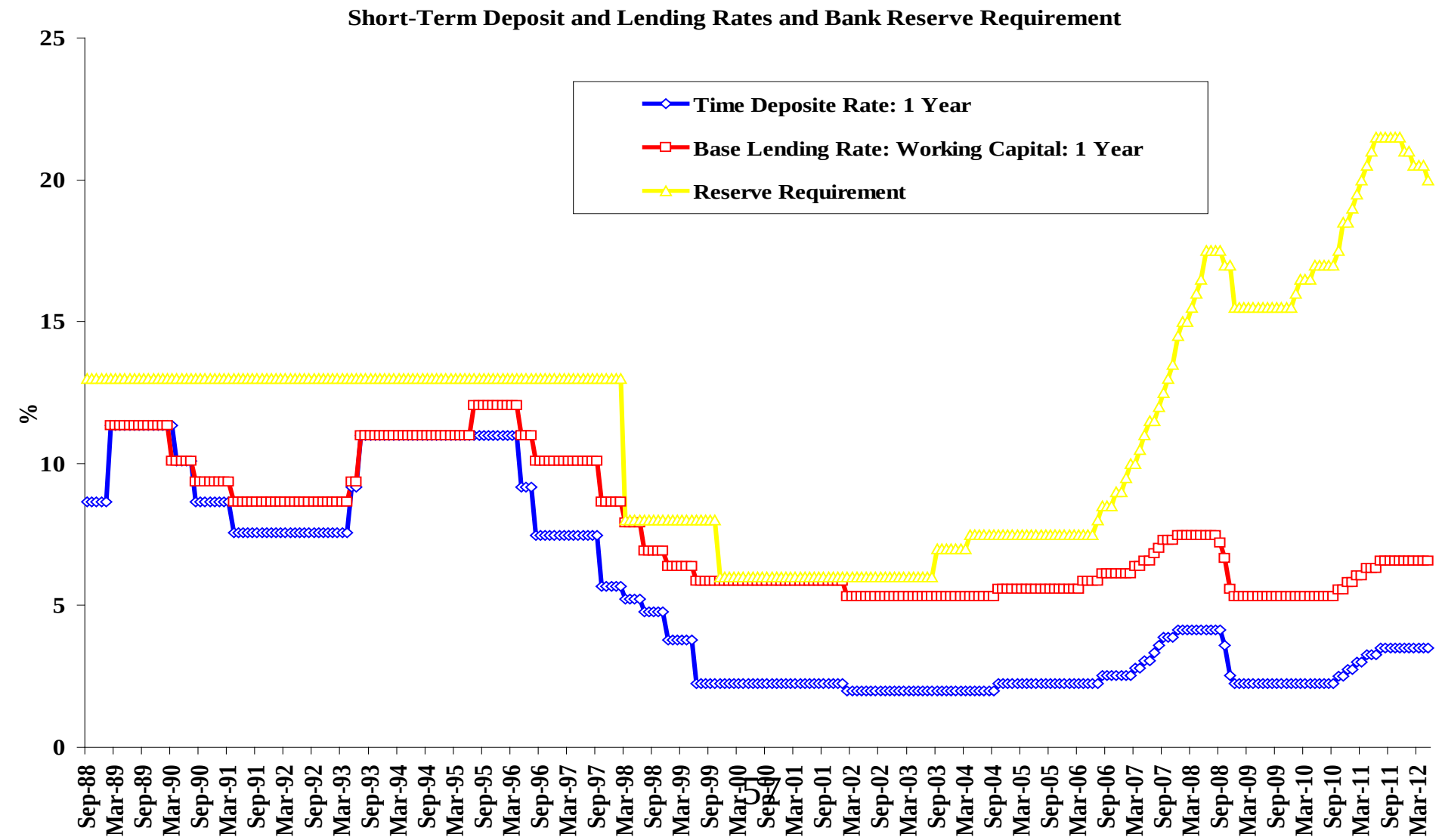
Average Housing Price of 36 Cities in China



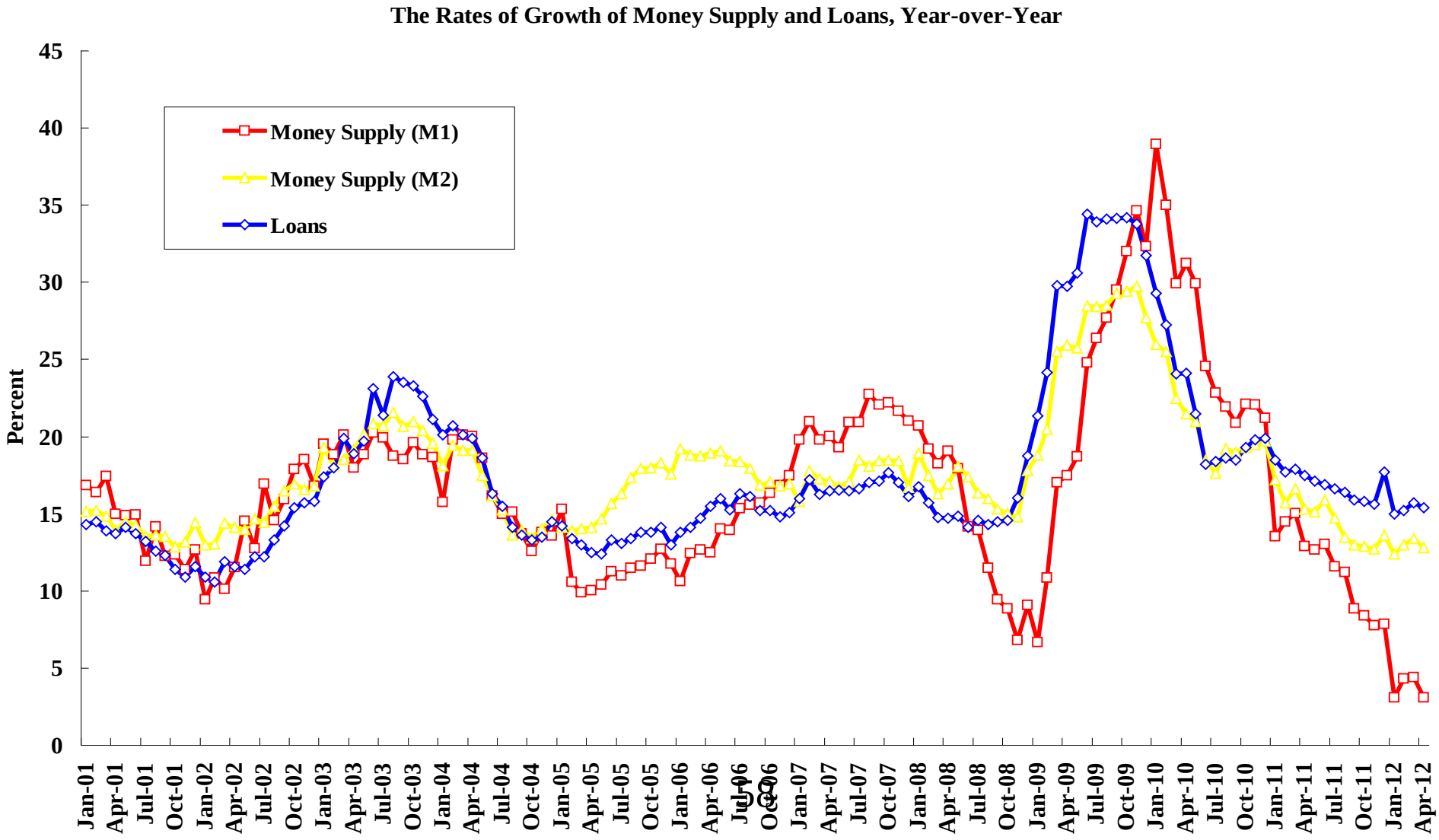
Price Index of New Residential Units, Selected Cities, Year-over-Year



Short-Term Deposit and Lending Rates and Bank Reserve Requirement



The Rates of Growth of Money Supply and Loans, Year-over-Year



The Macroeconomic Outlook

- There is not much any central bank can do about agricultural prices. No head of a central bank anywhere in the World has been able to control the weather or for that matter the hog cycle.
- The key in reining in increases in asset prices, especially real estate prices, is to ensure that there is a continuing dependable and steady supply of the assets going forward. Only the expectation of future supply availability can change price expectations. The Government must therefore try to create the expectation of regular increases of actual and potential supply through both its policy and its actual behaviour.

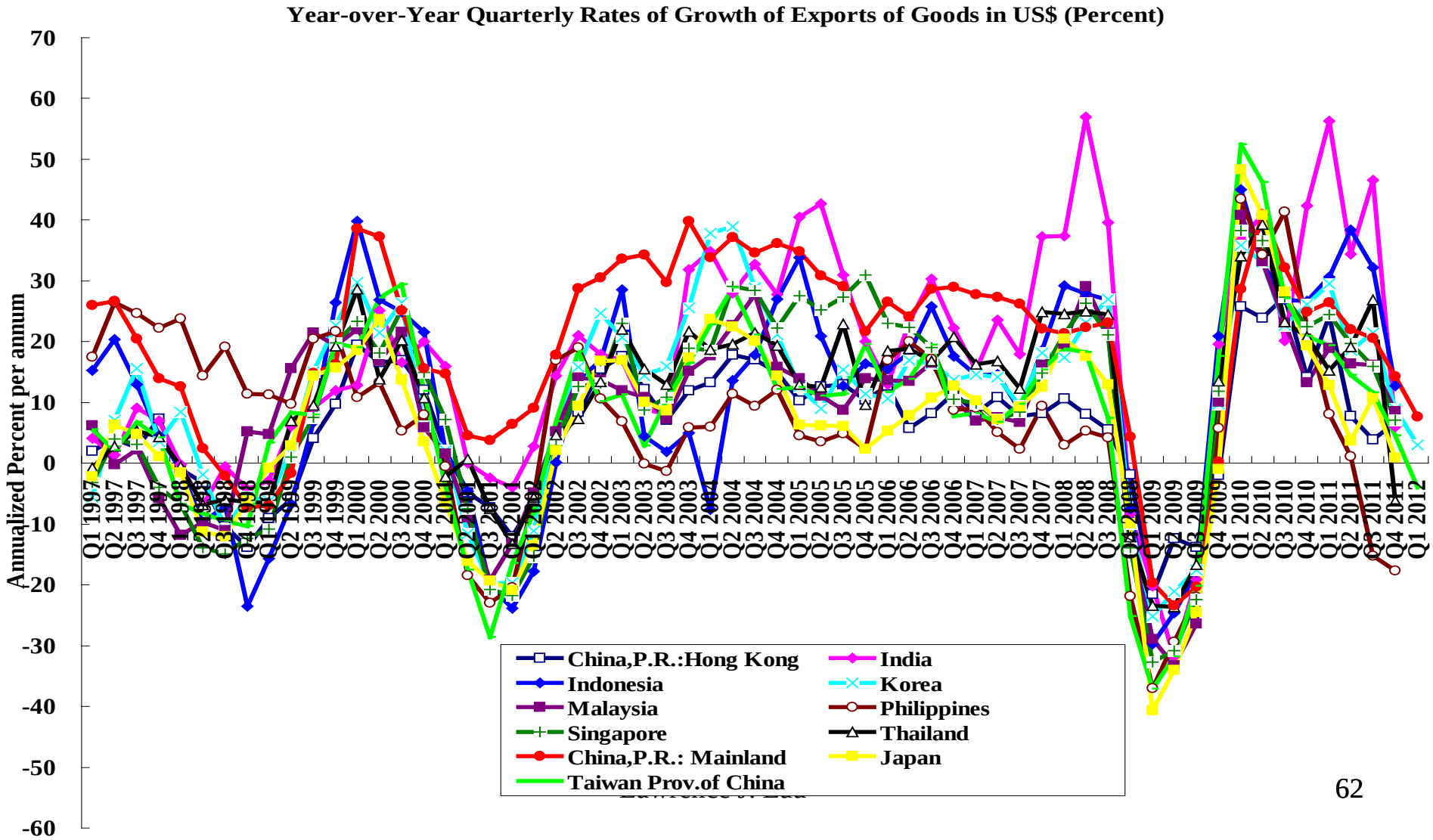
The Macroeconomic Outlook

- Even with increases in the levels of minimum wage rates in the different provinces, regions and municipalities, the real wage rate of unskilled, entry-level labour has basically remained stable and is expected to be stable for a long time because of the continuing existence of significant surplus labour in the Chinese economy as a whole.
- However, there is upward pressure on the real wage rate of skilled and experienced labour, which is actually in short supply, especially as Chinese enterprises move up the value-added chain.
- But given the trend of rapid expansion of Chinese tertiary education in recent years, with 6 million annual new graduates projected, the increase in the real wage rate of even skilled labour is likely to be relatively limited going forward.

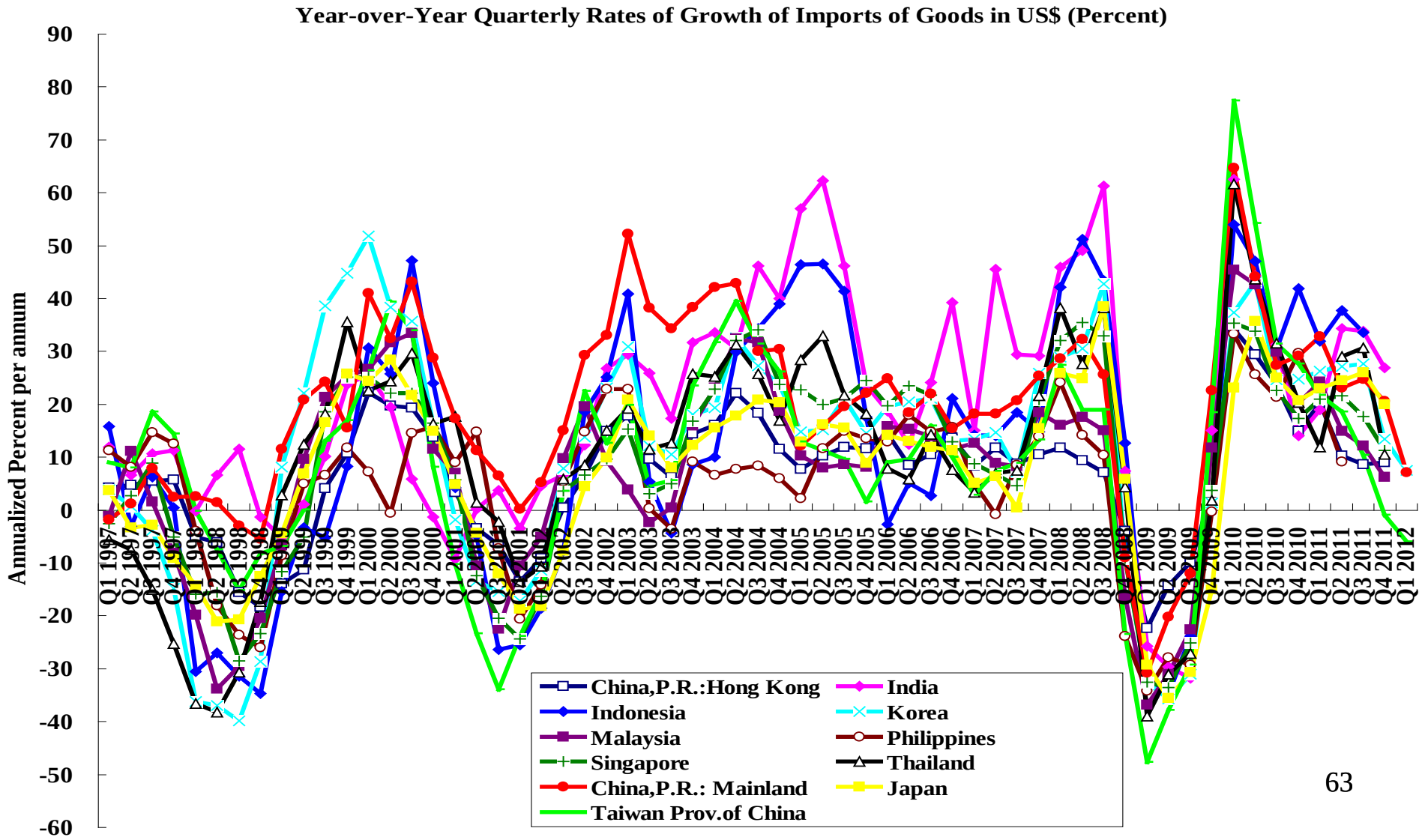
The Relative Unimportance of International Trade

- An important implication of the relatively low export dependence of Chinese GDP is that the rate of growth of Chinese real GDP is relatively stable, unlike the other East Asian economies, even as Chinese exports and imports fluctuate as widely as the exports and imports of other East Asian economies. (See the following charts on the rates of growth of exports, imports and real GDP of East Asian economies).
- In addition, China is a large, continental economy like the United States, that is relatively self-sufficient and is therefore relatively insulated from disturbances in the rest of the World.

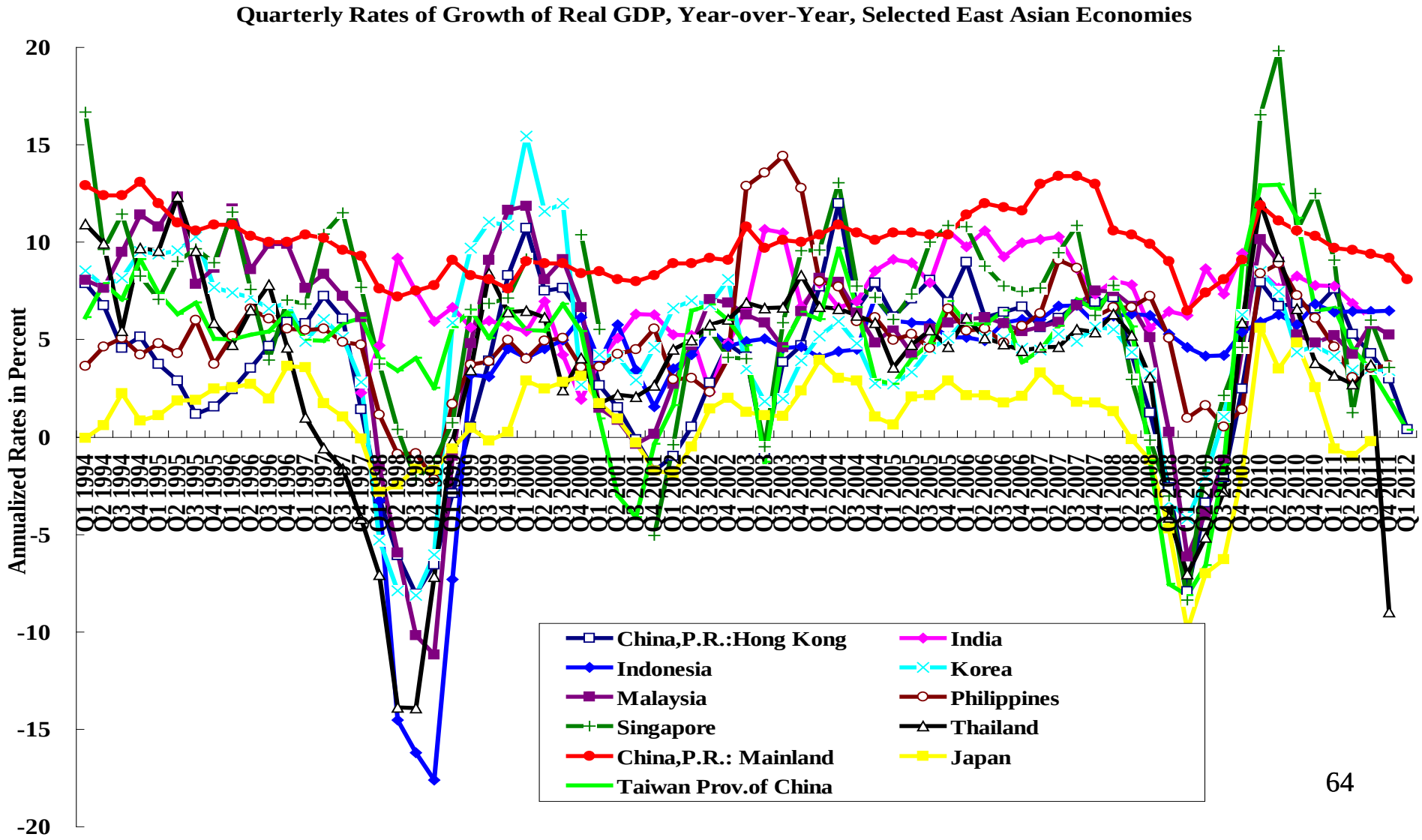
Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies



Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies



Quarterly Rates of Growth of Real GDP, Y-o-Y: Selected East Asian Economies



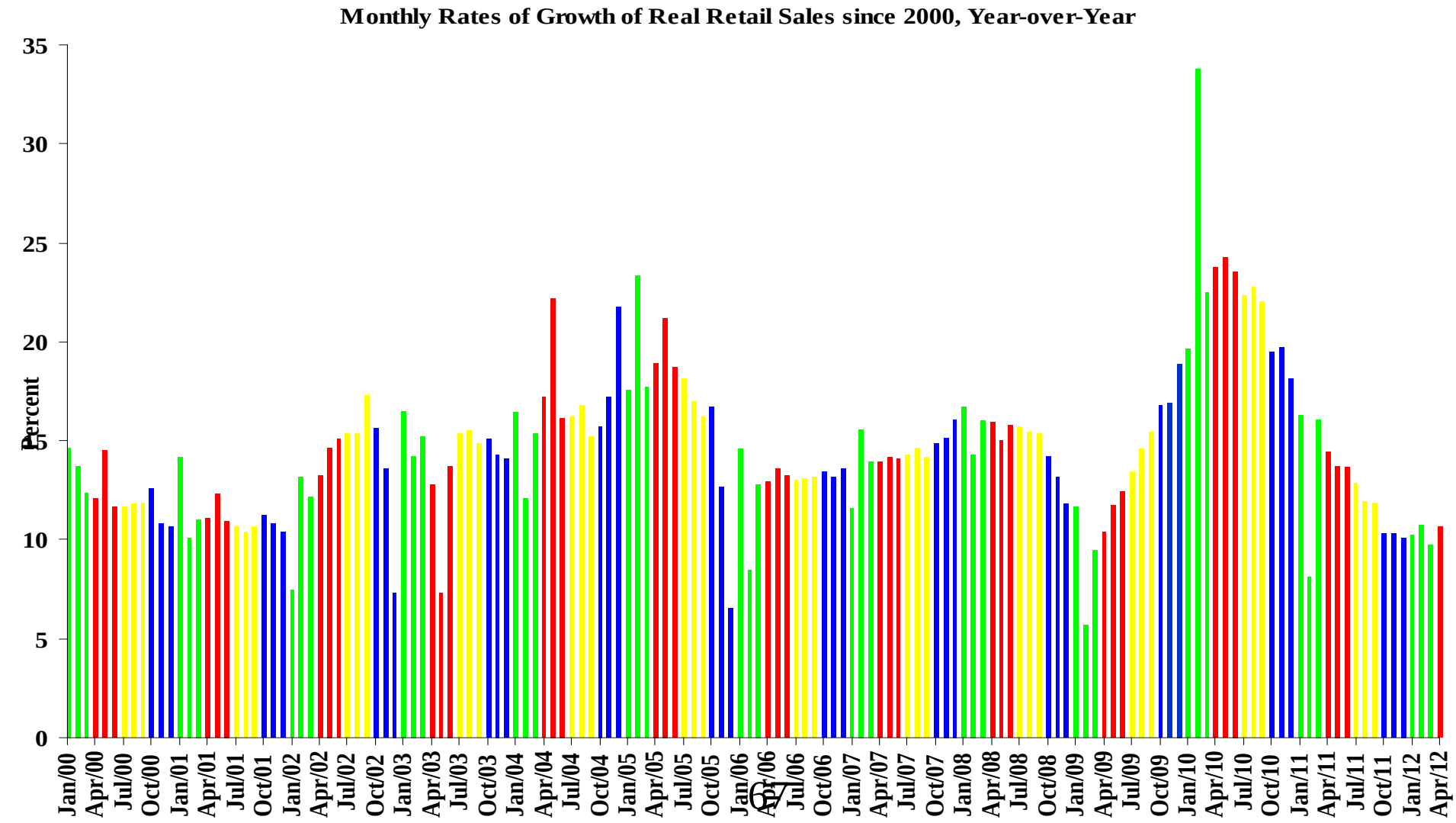
The Relative Unimportance of International Trade

- The fact that the Chinese economy has continued to grow at an average rate of almost 10% per annum since the beginning of the global financial crisis in 2007 is ample proof that the Chinese economy has been at least partially de-coupled from the rest of the World, and in particular, from the United States and Europe, both of which have been and still are mired in economic recession.

Sources of Sustainable Growth of Aggregate Demand

- Chinese household consumption is sometimes viewed as a potential sustainable source of growth of Chinese domestic aggregate demand.
- Chinese household consumption has actually been growing quite rapidly, as indicated by the double-digit monthly year-over-year rates of growth of real retail sales since the first quarter of 2009. The rates of growth of real retail sales have begun to slow since 2011 but still exceeded the rates of growth of real GDP or real household income for the corresponding period.

Monthly Rates of Growth of Chinese Real Retail Sales, Y-o-Y



Sources of Sustainable Growth of Aggregate Demand

- The Chinese household savings rate, as distinct from the much higher national savings rate, currently stands at approximately 30% (for urban households).
- However, the consumption-savings behaviour of Chinese households on the Mainland today appears to be little different from ethnic Chinese households in Hong Kong and Taiwan at the same level of per capita household income, with an average savings rate of urban households of approximately 30%. Thus, the Chinese household savings rate is not likely to fall significantly in the foreseeable future.

Sources of Sustainable Growth of Aggregate Demand

- Chinese household consumption can be expected to increase significantly faster than GDP only if Chinese household (disposable) income as a share of GDP rises significantly. There are structural reasons why this is unlikely to occur in the near term even though in the long term, the income share of labour, which currently stands at less than 50%, is likely to rise in China.
- Continuing Chinese economic growth beyond 2011 will therefore have to depend mostly on the growth of internal demand and not on exports, and, as analysed above, not on the growth of household consumption per se in the absence of a significant sustained increase in the share of household income in GDP.
- Household income can be increased through wage increases but also through increases in the cash dividend payouts from state-owned enterprises. Recently, the Chinese Government has called for an increased cash payouts from state-owned enterprises.

Sources of Sustainable Growth of Aggregate Demand

- Increased cash payouts have many advantages in addition to increasing household income and thereby household consumption.
- They increase government revenue, both directly, as the government is a major shareholder in many publicly listed enterprises and will receive the increased cash dividends, and indirectly, through the increased individual income taxes collected on the cash dividends paid to the other shareholders. The increased government revenue can in turn be used to increase public consumption—e.g., the provision of public services such as education and health care, the preservation and restoration of the environment, etc.
- An increased cash payout by the state-owned enterprises reduces their excess retained earnings so that they can no longer make investments at will—it will have to apply for loans and hence their investment projects will have to be justified to and evaluated by the lenders.

Sources of Sustainable Growth of Aggregate Demand

- Increased cash payouts may make long-term holding of shares more attractive and may attract a different breed of investors. It will encourage investors to hold their shares longer and hence indirectly improve corporate governance as only long-term shareholders pay any attention to corporate governance.
- An increased cash payout provides a support level for the price of the shares of a publicly listed enterprise. Thus, the government does not need to worry as much about supporting the market.
- The ability to pay cash dividends on the part of an enterprise actually provides a real verification of the true profitability of an enterprise. An enterprise with only virtual or fictional or only accounting profits does not have the ability to pay out cash dividends whereas it can always declare stock dividends.

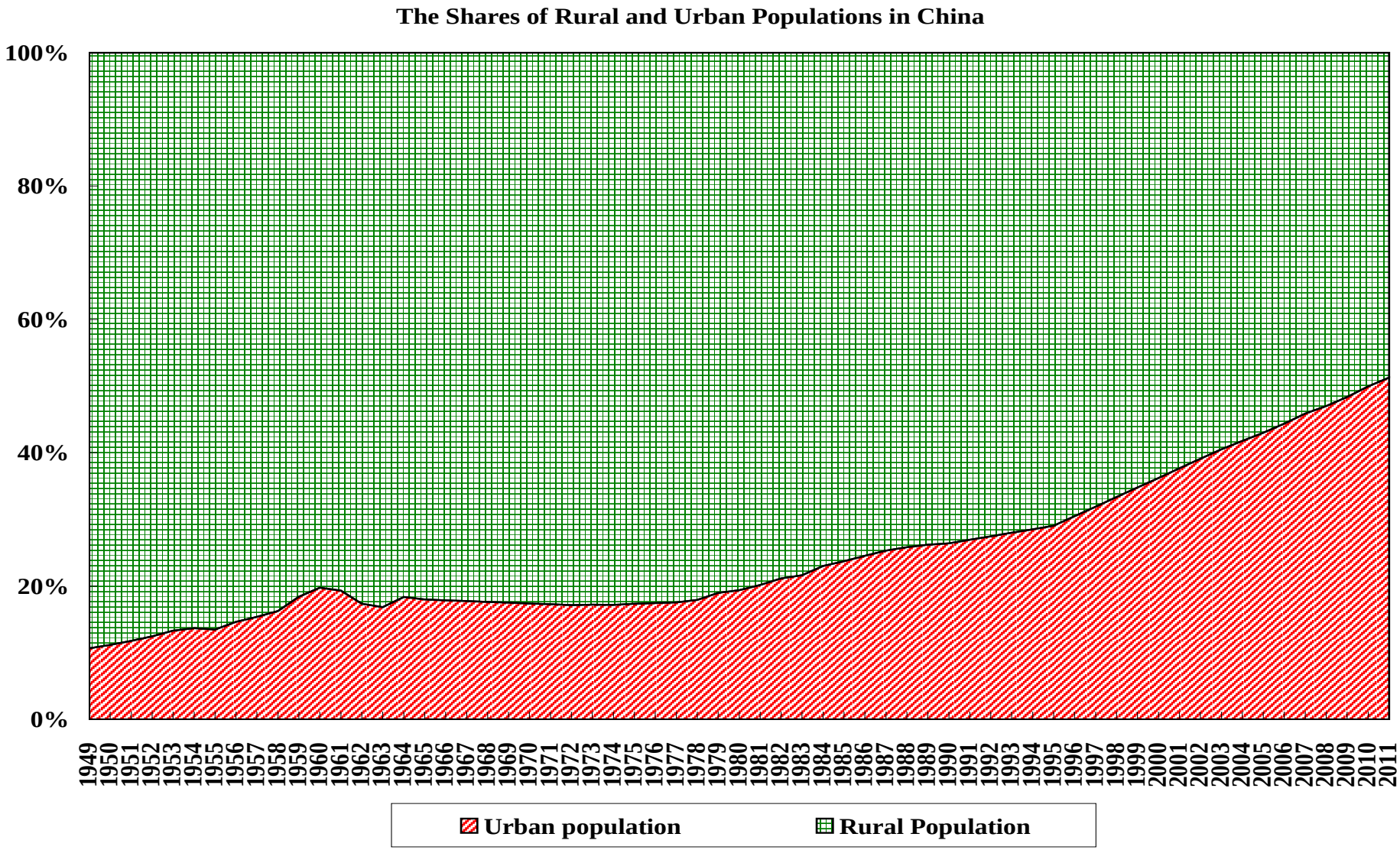
Sources of Sustainable Growth of Aggregate Demand

- The possible areas that have the potential of generating sustainable increases in aggregate demand, in addition to household consumption and public infrastructural investment (e.g., high speed railroads, mass-transit systems, power plants, etc.), include:
- (1) Acceleration of urbanisation;
- (2) Residential housing;
- (3) Education and health care and the application of high technology in these sectors;
- (4) Conservation of energy, environmental protection and preservation, and promotion of the green economy.

Urbanisation

- The share of rural population in China was just under 90% in 1949. By 1978, the beginning of the Chinese economic reform and opening to the World, the share of rural population was 82%. At the end of 2010, the share was 51%.
- By 2011, the share of rural population has fallen to 48.7%. It is expected to continue to fall during the period of the Twelfth Five-Year Plan, 2011-2015, to 47%. It is possible that this goal may be exceeded.
- The rate of decline of the share of rural population has been approximately 1 percentage point per year, about the same rate of decline as the share of employment of the primary (agriculture) sector.
- It is expected that the share of rural population will continue to decline by 1 percentage point a year until 2040, when the share of rural population will have fallen to below 25%.

The Shares of Rural and Urban Population in China, 1949-Present



Urbanisation

- Instead of making the existing cities larger and more crowded, urbanisation should proceed by building new cities in the rural areas, taking advantage of the traditional market towns and bringing capital and technology to labuor rather than the other way around.
- Urbanisation in the rural areas is greatly facilitated if the rural households currently living on and working with their land can have their property rights recognised and made transferable.

Urbanisation

- The inter-urban communication and transportation infrastructure needs to be further planned and improved, especially with the building of new cities. Super-high-speed trains are promoted as the preferred mode of transportation between major cities over air travel, resulting in significant savings of time as well as energy consumption.
- Central planning of new cities, with regard to their locations, layouts, land use, densities, and intra-urban communication and transportation infrastructure, is necessary—left entirely to itself, the market system will result in urban sprawls and slums and a heavy reliance on the private automobile, which neither China nor the World can afford from the point of view of energy consumption and carbon emission.

Urbanisation

- Mass-transit systems should be the principal means of intra-urban transportation for existing as well as new cities, and as mentioned above, this requires planning and cannot be left to the market.
- With at least a couple of hundreds of Chinese cities of over say 2 million in population and requiring mass-transit systems, the planning, designing, building and operating mass-transit systems can become a huge new industry with significant domestic and eventually export demands.
- In order to economise on the use of the scarce land resource, and to assure the efficiency and environmental friendliness of the urban transportation system, high density land use should be mandated in the cities.

The Residential Housing Sector

- One important source of sustainable aggregate demand is owner-occupied residential housing. Despite significant development of residential housing during the past thirty years, there is still a great deal of room for it to grow, especially in the interior provinces and regions and for the middle-to-lower-middle income households.
- Owner-occupied residential housing has been a major engine of growth for many countries and regions for decades during their periods of fastest economic growth. There is no question that there is a huge potential demand in China.

The Residential Housing Sector

- The demand for residential housing also generates with it the derivative demands for furniture, electric home appliances such as refrigerators, washing machines, and television sets, curtains, carpets, household goods and services and with them a great deal of employment and activities for not only large enterprises but also small and medium enterprises.
- In order to promote owner-occupied residential housing for all, one has to assure that there is both the supply and the demand. Supply can be promoted by making sure that land is available at an affordable cost and is used efficiently (that is, predominantly high-density use). Demand can be promoted by making available long-term (say 35 years), fixed interest-rate mortgages.

The Education and Health Care Sectors

- This is the time to increase support for the education sector across the board—primary, secondary and tertiary—and for the health care sector, expanding the accessibility, availability and affordability in the rural areas.
- Both the physical structures as well as the human resources of primary and secondary schools and of hospitals need to be upgraded, especially in the rural and low-income areas.

The Education and Health Care Sectors

- In addition, China should adopt a policy of assuring low-cost or no-cost access to the internet by all students in China everywhere, all the way down to the primary school level. Promoting and making universal the laptop or the tablet is one way to achieve this goal. Many Chinese households are able to afford laptop computers—the difficulty is having inexpensive and ready access to the internet.

The Education and Health Care Sectors

- Making the internet accessible, available and affordable everywhere in China (certainly from all the educational institutions) will greatly narrow the inequality of education (and information) between the urban and rural areas and reduce the so-called digital divide between the rich and the poor. It will be a great equaliser, because on the internet, for examples: a student in Qinghai, one of the poorest provinces in China, will have more or less the same access to information as a student in Shanghai; large and small enterprises will compete more or less equally.
- This will also create a great deal of domestic demand for the high-technology sector.

The Education and Health Care Sectors

- Public health and preventive medicine should be widely promoted. Food and drug safety should be a top priority and high technology can be applied to testing and certification of food and drugs.

Environmental Protection and Green Technologies

- Green technologies can find significant application in the residential housing sector—in terms of heating, cooling, lighting, provision of electricity and hot water, etc.
- The mass-transit systems provide an indispensable alternative to the use of the automobile. "A car in every garage" would be a nightmare for China and for the World. Cities should be planned so that the residents do not require the use of an automobile in their everyday life (although they may well own an automobile for weekend and leisure use).

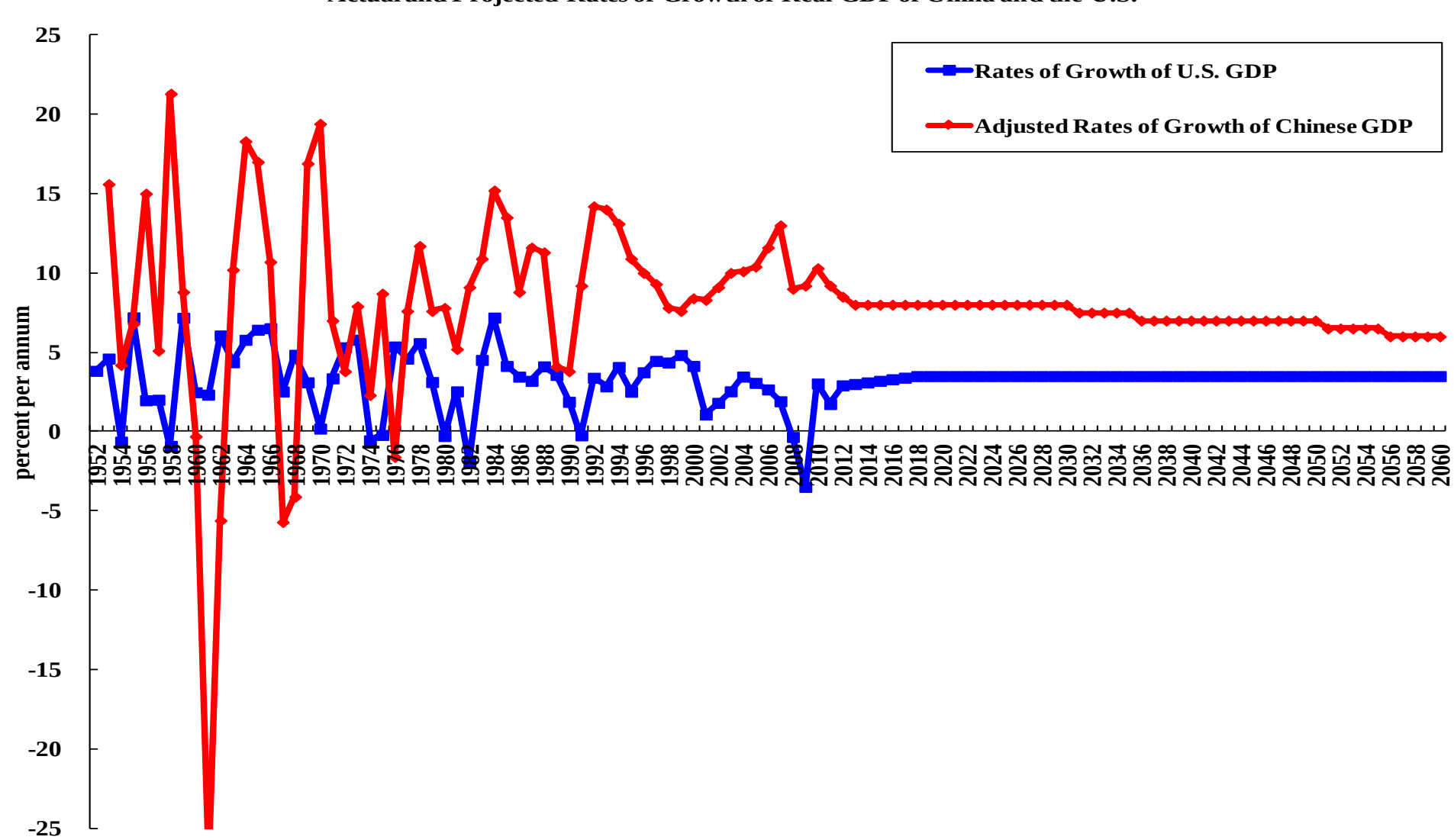
Environmental Protection and Green Technologies

- China has an advantage in introducing technologies for green or greener vehicles because it has relatively little sunk costs. (An electric car consortium has been formed recently to develop an electric car suitable for China.) China also has a substantial incentive in developing clean coal technologies, having large coal reserves itself. China also has very large shale oil and gas reserves.
- It can also introduce and promote alternative renewable and clean sources of energy, such as solar power and wind power based on its own huge internal demand. However, the most promising directions are in energy conservation—the energy consumption/GDP ratio in China is still too high relative to other economies at a similar stage of economic development—and in the increased utilisation of hydro-electric and nuclear power for electricity generation.

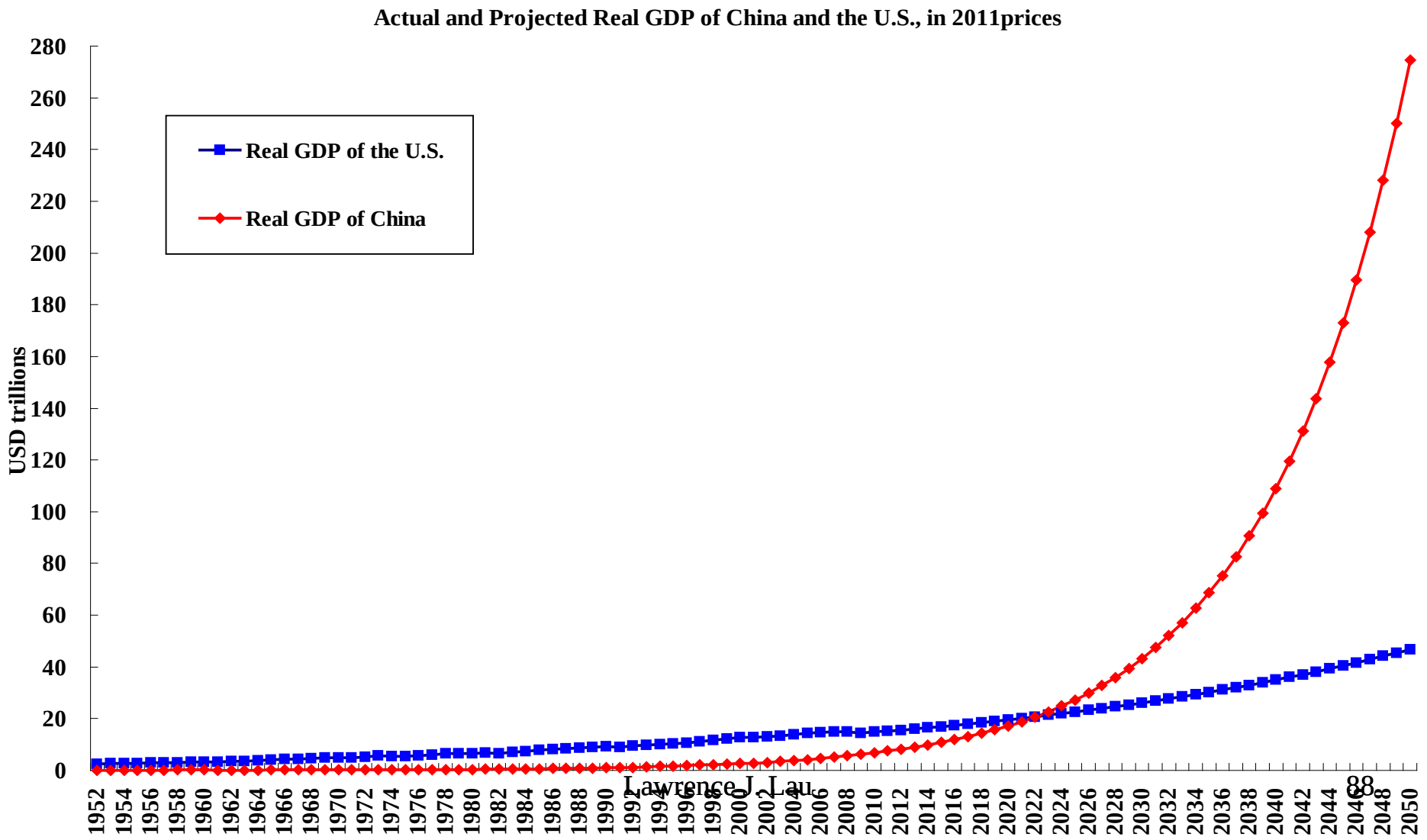
Projections of the Future

- If current trends continue, with the U.S. economy recovering slowly but surely, East Asia as a whole will surpass the United States in terms of aggregate GDP with China perhaps contributing the highest proportion of the total by 2015.
- Chinese real GDP is projected to overtake U.S. real GDP in approximately 15 years' time--around 2026, at which time both Chinese and U.S. real GDP will exceed US$23 trillion (in 2011 prices). (Bear in mind that in the meantime, the U.S. economy will also continue to grow, albeit at rates lower than those of the Chinese economy.)
- By this time, China and the U.S. will each account for approximately 15% of World GDP.

Actual and Projected Growth Rates of Chinese and U.S. Real GDP, percent p.a.



Actual and Projected Chinese and U.S. Real GDP, in 2011 prices



Projections of the Future

- By 2026, Chinese real GDP per capita is projected to exceed US$16,400, which will still only be a quarter of the projected US per capita real GDP of US$66,000.

Concluding Remarks

- The long-term sustainable sources of Chinese aggregate demand will be internal: urbanisation (building new cities), public infrastructure, mass-transit systems, household and public consumption, residential housing, investment in education and health care, environmental protection and preservation, energy conservation and renewable energy, and the green economy.
- Consumption will rise, as GDP per capita and wage rate rise and the social safety net is gradually perfected. But the national savings rate may remain high for a long time.

Concluding Remarks

- International trade will continue to be somewhat important, but not critical, to the growth of the Chinese economy. Exports as a share of Chinese GDP will probably continue to decline over time, as befitting a large, continental economy. Chinese economic growth will be marginally, but not critically, affected by a large decline in its exports, as demonstrated by its experience in the past several years as well as during the 1997-1998 East Asian currency crisis. Thus, it will be able to survive even prolonged economic recessions in the European and U.S. economies.

Concluding Remarks

- For 2012, the short-term economic targets of the Chinese Government are to achieve a real rate of growth of 7.5 percent and to control the rate of inflation to below 4 percent. I am confident that both targets are achievable.